



# IPO

## HANDBOOK

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A circular graphic with a white-to-blue gradient, containing the text '3<sup>RD</sup> EDITION'. The circle is set against a background of abstract, layered blue and teal shapes that resemble a stylized landscape or a series of overlapping pages.

**3<sup>RD</sup> EDITION**

# Initial Public Offerings: Considerations for Business Owners and Executives Taking Their Company Public

**THIRD EDITION**

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# About the Authors

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# About PwC

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Our purpose—to build trust in society and solve important problems—is at the core of everything we do. It guides how our global network of more than 328,000 professionals in 152 countries deliver sustained outcomes to our clients. PwC provides professional services across two segments: Trust Solutions and Consulting Solutions. Within these segments we bring a range of capabilities to help organizations solve faster, solve more, and realize more value. These capabilities include cloud and digital, deals, ESG, cybersecurity and privacy, governance/boards, risk, transformation, tax services and much more.

Whether an acquisition or divestiture, IPO or debt offering, restructuring or alliance, our deals professionals have seen it before and know how to support your transaction efficiently. Our experience combined with an intimate knowledge of your business delivers the objective advice and data-fueled insights you need to make confident decisions at the right time.

When pursuing an IPO, public debt issuance or another type of capital market event, the right experience is the runway to ongoing success, and PwC can help you set the course. We advise clients throughout the life cycle of the IPO process, from pre-IPO readiness preparation to the offering process and beyond.

Accelerate a confident, successful public company journey that builds a lasting impact by visiting [www.pwc.com/us/iposervices](http://www.pwc.com/us/iposervices) for more IPO specific PwC materials and insights.

# About Simpson Thacher & Bartlett LLP

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Simpson Thacher & Bartlett LLP is widely recognized as one of the world's top law firms. With more than 1,000 lawyers across eleven offices worldwide, we help our clients address complex matters across the spectrum of corporate and litigation matters.

Having advised on more than 300 IPOs over the past decade, we have unsurpassed experience guiding issuers and underwriters through the process of going public. We have been ranked in the top 3 law firms as counsel to the issuer or underwriters in U.S. IPOs in 12 of the last 15 years and have served as counsel in connection with many of the largest and most complex IPOs in the world, including Bumble (largest U.S. IPO by a U.S. issuer in 2021), Airbnb (second largest technology IPO of 2020), Avantor (largest healthcare IPO in U.S. history (2019)), 10x Genomics (largest life sciences IPO of 2019), Dropbox (largest venture-backed software IPO in history (2018)), LINE Corporation (2<sup>nd</sup> largest technology IPO of 2016), First Data (largest U.S. IPO of 2015), Alibaba (2<sup>nd</sup> largest IPO in history (2014)), Hilton Worldwide (2<sup>nd</sup> largest U.S. IPO of 2013), Facebook (largest U.S. IPO of 2012), HCA Holdings (largest U.S. IPO of 2011), Blackstone (largest U.S. IPO of 2007), MasterCard (largest U.S. IPO of 2006) and Google (largest technology IPO of 2004).

Clients value our broad expertise in preparing companies, their founders and equity sponsors for their IPOs, navigating the complexities of the offering process and dealing effectively with the myriad issues that arise in public offerings, the stock exchange listing process and issuers' ongoing reporting obligations and investor relations issues. In addition, we have deep experience advising underwriters and benefit from long and established relationships with most of the world's major and mid-market investment banks.

For more information, please visit us at [www.simpsonthacher.com](http://www.simpsonthacher.com).

# About Donnelley Financial Solutions

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DFIN is the leading provider of innovative, software and technology-enabled financial regulatory and compliance solutions. Supporting every stage of our clients' business and investment lifecycle, DFIN provides regulatory filing and transactional deal solutions to public and private companies, mutual funds, and other regulated investment firms. As the global leader in IPO services, DFIN IPO solutions and experts help you successfully navigate the intricacies and prepare for life as a public company. When it comes to capitalizing on key moments in the IPO process, DFIN leads the way – and we have the numbers to prove it. Over the last six years, DFIN has supported a majority of PE and VC-backed IPOs, filed 700+ traditional IPOs, partnered on 70% of traditional IPOs valued at more than \$100M for US-based issuers, and serviced 350+ SPACs.

## Corporate Repositories and Virtual Data Rooms

Our corporate repositories empower teams to easily manage, share and protect files in a secure and cost effective environment, so you can secure data, protect privacy and streamline projects. Venue virtual data rooms (VDRs) help you safeguard and share your most sensitive documents with all your stakeholders with easy-to-use privacy scans, contract analysis and multi-file redaction for full transparency and regulatory compliance.

## Financial Reporting and SEC Filing

Starting financial reporting early is key to a successful IPO. Drive efficiencies and optimize your financial reporting with ActiveDisclosure while leveraging our 24/7/365 financial expertise to reduce cost and financial risk. Our financial reporting and SEC filing software streamlines S-1 reporting as you prepare for your IPO and helps you to develop the robust systems needed for success. Once public, leverage ActiveDisclosure for Proxy, ESG, beneficial ownership and other compliance disclosures.

## Expert DFIN Support

Augmenting our innovative financial solutions is 24/7/365 support from detail-oriented, tenured, certified, highly experienced and highly trained subject matter experts. DFIN EDGAR reporting and deal experts keep everyone aligned on process while delivering best-practice advice, hands-on assistance and regulatory guidance to empower corporate teams to achieve their goals.

To discover all the power of DFIN's IPO solutions, visit <https://www.dfinsolutions.com/solutions/ipo>.

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# I. Introduction

If you are picking up this book you may be contemplating an initial public offering of your company. The authors have each been advising companies on going (and being) public for decades—Doug and Meredith at PricewaterhouseCoopers (PwC) and Josh and Will at a law firm (Simpson Thacher). Over the years we have met with countless business owners and executives who are considering an IPO and have found that they ask many of the same questions regardless of the size of their company or the industry in which it competes.

- What is the basic process for an IPO?
- How long does it take?
- How much does it cost?
- What things should I be thinking about now, when a possible IPO is still a fair way off?
- What kinds of changes to my finance and accounting organization will I need to make?
- What kinds of things does the SEC care about and how can I anticipate these?
- How will my company be valued and how will the stock actually get sold?

We wrote this short book to answer these kinds of questions directly and without a lot of technical jargon.

This book is not, however, a “how to” manual written for other practitioners or a comprehensive survey of the myriad legal and accounting rules that apply. If you choose to move forward with taking your company public, you should engage advisors who have the practical, real world experience to guide you through the thicket. For example, we have not identified the relatively limited number of places where the topics discussed would vary if your company is organized outside of the United States and qualifies as a “foreign private issuer” nor discussed at any great length, the process of going public through a business combination with a special purpose acquisition company (“SPAC”). Readers who are nonetheless interested in the detailed nuts and bolts will find that there is already a fairly extensive catalogue of multi-volume treatises out there that have been written covering the technical aspects of the process.

The founders, CEOs, CFOs and GCs who are far enough along in their thinking about an IPO to come in to meet with us are typically quite familiar with the anticipated benefits—enhancing their company’s access to capital, providing it with a publicly traded stock that can be used as an acquisition currency and compensation tool, enhancing its brand and market profile and providing a public market valuation and path to liquidity for its owners.

On the other hand, and apart from a general understanding that it will result in a lot of additional costs and hassles, we have found that the disadvantages of becoming a public company are frequently more hazy. If only to avoid IPO clients later saying “how could you let me do this!?”, we always go over with them not only the hard dollar costs of becoming and being a public company, but also the less tangible risks that going public could adversely impact the company’s culture, distract its leadership from effectively managing to its long-term objectives, decrease the “nimbleness” of its strategic decision-making, expose it to a much greater level of public scrutiny (including heightened attention from regulators and enforced public disclosure of competitively and otherwise sensitive information) and erode its existing owners’ control. It is worth emphasizing that the burdens of being a public company only increase over time, often in ways we cannot currently predict. Even since the time we published the prior edition of this book, the disclosure requirements applicable to public companies have expanded in multiple respects. Public companies here in the United States, and especially newly public companies, are also potentially subject to class action lawsuits (many of dubious merit) if their stock drops. It may reveal an interesting and humorous insight into human nature that this lecture rarely has either dissuaded a client from proceeding with an IPO or prevented the very same client from subsequently expressing shock at the consequences.

The “initial public offering” in one form or another has been around since ancient Rome and its development can be traced through the invention of the joint-stock company in 16<sup>th</sup> century Europe to the introduction of broad corporate limited liability laws in New York in the early 1800s. But one thing about the new issue market has been true throughout its history—it opens and closes sporadically and without much warning, as has been seen recently amid a challenging macroeconomic environment. While the IPO market is correlated with demand for equities generally as reflected in the broader stock price indices, it is also uniquely tied to market psychology as to whether new offerings are considered “hot.” As you will learn in the following pages, the process of preparing for and executing an IPO typically takes anywhere from six months to two years. Where a company has made the strategic decision to become publicly traded, the standard approach is to move forward with preparations without being distracted by the day-to-day gyrations of the stock markets so that it is in a position to execute its debut at a time of its choosing when the markets are receptive.

We have tried to distill our experience into straightforward answers to your questions in the following pages—we hope that you find it useful. However, to avoid burying the lede, our principal messages to those contemplating an IPO are:

- start to prepare early;
- engage experienced advisors;

- objectively assess your readiness not only for the IPO process itself but also for life as a public company, including the attendant demands on your company's finance organization;
- develop realistic work plans based on that assessment to redress gaps or areas of weakness in addition to the execution of the IPO itself; and
- methodically and efficiently implement these plans, considering interdependencies with other initiatives.

## II. Overview of the IPO Process

### A. What are the principal phases of the IPO process? How long does it take?

An IPO may be thought of as having several principal phases—the preparatory period prior to the formal engagement of underwriters and kicking off the transaction, the period between the transaction kick-off and the initial submission of the registration statement to the SEC, the period during which the staff of the SEC reviews the company’s registration statement, and the exciting final few weeks where the transaction is launched and marketed to investors. At the conclusion of the roadshow, the IPO is priced and the company’s stock begins trading, commencing the company’s life as a public company with obligations to a new set of stakeholders. Successfully meeting investor expectations during the initial post-IPO trading and reporting of financial results is critical.

**Pre-transaction preparation.** Initially, from six to 18 or even 24 months or more prior to making an initial submission of a registration statement to the SEC, you will prepare for the IPO process and for life as a public company thereafter. One of the most important parts of this preparation will involve beginning to prepare the SEC-compliant financial statements to be included in the IPO registration statement itself and upgrading and enhancing your financial reporting capabilities so as to permit your company to produce SEC-compliant financial reporting on a timely and recurring basis going forward. During this phase, you should evaluate the capabilities and independence of your outside audit firm and assess whether any changes are warranted, assess which financial statement periods may be required depending on the ultimate desired IPO timeline, and begin to prepare auditor reviewed (albeit not audited) interim financial statements in addition to your annual audited statements, if you do not already do so. Note, in addition to any interim (year to date) financial statements that may be required, there is often additional quarterly information requested for the marketing process, discussed in greater detail in Chapter VI (Your Relationship with the Underwriters), which may require additional preparation and involvement from your auditors. It is also worth noting that financial statements included in the registration statement will be subject to the auditing standards of the Public Company Accounting Oversight Board (“PCAOB”) instead of the private company auditing standards of the American Institute of Certified Public Accountants, which oftentimes lead to a lower level of auditor materiality thresholds and additional auditing procedures. In addition to your auditors, many companies also engage accounting advisors to help, which we’ll discuss in greater detail in Chapter III (Planning Ahead—What Should I Be Thinking About Now?).

The preparation of SEC-compliant financial statements (potentially including pro forma financial information and financial statements for acquired businesses and equity method investees) and the development of the capability to produce these in a timely way going forward is almost always the “longest

pole” in the IPO timeline and the area most demanding of the up-front investment of resources. Public company reporting requirements often require an organization to add and retain employees who possess skill sets a private company does not typically have. For example, 78 percent of recently public companies participating in a PwC survey hired between one and five new staff members, specifically to increase their SEC reporting capabilities.

It will also be crucial for you to develop, to the extent that you do not already have it, a robust financial planning and analysis (“FP&A”) capability. It would be difficult to overemphasize the importance to the IPO process (and to life as a public company thereafter) of being able to produce a reliable financial forecasting model. Chapter IV (Building a Public Company Finance Organization) provides a deeper dive into this most important area.

In addition to building out its finance capabilities, a company preparing for an IPO needs to understand how it will be viewed and valued by the market and prepare itself to be positioned appropriately. You should also think about whether there are changes to your corporate or tax structures or ownership or compensation arrangements that will be desirable or necessitated as a result of the IPO—sometimes it can be less costly to implement these types of changes in advance rather than on the eve of the transaction itself or subsequently as a public company. A company should evaluate its control environment and begin to design and implement processes and controls that will enable it to comply with the requirements applicable to public companies. Finally, you should also perform the difficult task of taking a fresh look at your company and consider whether you should revisit the historical approaches you have taken to risk and to practices and arrangements that may be less suitable for a public company than a private one. Chapter III (Planning Ahead—What Should I Be Thinking About Now?) discusses in greater detail selected areas that we have found from past experience to be productive objects of focus for companies preparing for an IPO.

**Post kick-off/Pre-submission.** Two to six months prior to the initial submission of the IPO registration statement to the SEC, you will typically formally mandate your lead underwriters and kick in to high gear preparation of the registration statement itself, including developing and refining the investment thesis for the offering. The preparation of the registration statement, discussed below in somewhat greater length, is a major undertaking, entailing a cooperative effort by the company and its counsel and its auditors working with the lead underwriters and their counsel.

During this phase, the lead underwriters and the legal counsels will conduct a thorough review of the company, referred to as a “due diligence” investigation, including intensive meetings with management and review of the company’s legal documentation, as well as background checks on its leadership and calls with a selection of the company’s important customers or other counterparties.

The CEO and CFO will also typically have initial meetings with the research analysts who cover the company's sector at the lead underwriting firms. The views of the analysts on the company and its industry will not only be an important input into the decision by the "commitment committees" of the underwriting firms whether or not to proceed with the transaction, but will also be a critical factor in the success of the offering and subsequent trading as the analysts share these views with investors. For a more detailed discussion of the role the analysts play in the successful execution of an IPO, see Chapter VII (Marketing, Pricing and Distribution).

**SEC review.** Once the registration statement is in shape for SEC review you will submit it to the SEC. Since 2017, the SEC has permitted all IPO companies initially to submit their registration statement to the SEC on a confidential basis, a dispensation previously available only to "emerging growth companies." The SEC staff will take approximately four weeks to perform their initial review of the registration statement and issue their initial comment letter (although it's worth giving a shout out to the SEC staff because they really do try to adhere to a four-week time frame).

Following receipt of the initial SEC staff comment letter, you will respond by resubmitting your registration statement, revised to reflect updates made in response to the SEC staff's comments and, if required, updated financial statements and accompanied by your own letter explaining (politely!) your responses to each of the staff's comments. In an IPO there will typically be several rounds of SEC staff comments and resubmissions of the registration statement in response, with the overall time required for this phase taking from two-and-a-half to four months, or even longer if problematic SEC staff comments are encountered or if the company lollygags in moving forward. It is worth noting that no earlier than 20 days after the publicly filed registration statement is declared effective, all prior comment letters and responses, and related revisions, are also made publicly available (including those made during the initially confidential phase of the SEC's review process). Chapter V (Dealing with the SEC— What Do They Care About and How Can We Navigate the Process as Smoothly as Possible?) provides a more in-depth look at the SEC review process.

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An "emerging growth company" ("EGC") is any issuer that had total annual gross revenues of less than \$1.235 billion (adjusted for inflation every five years; prior to September 20, 2022, the threshold was \$1.07 billion) during its most recently completed fiscal year. A company that is an emerging growth company on the first day of its fiscal year will no longer qualify as an emerging growth company upon the earliest of:

- the last day of its fiscal year following the fifth anniversary of the first sale of its common equity securities in a public offering;
  - the last day of a fiscal year during which it had total annual gross revenues of \$1.235 billion or more (adjusted for inflation every five years, with the next reset expected to occur in 2027);
  - the date on which it has, during the previous three-year period, issued more than \$1 billion in non-convertible debt; or
  - the date on which it is deemed to be a "large accelerated filer" (a company that has been public for at least twelve months, has filed one Form 10-K, and has a public float of at least \$700 million).
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During the SEC review period, you and the underwriters (and your respective counsels) will work on the presentation to be used during the “roadshow” and any preceding “testing-the-waters” meetings described below and in Chapter VII (Marketing, Pricing and Distribution). It is also during the SEC review period that you, with the assistance of the investment bankers, will refine your financial model and then separately conduct more intensive meetings with the underwriting firms’ research analysts. Informed by the company’s model, these analysts will build their own financial models that will form the basis for their views on valuation and their future research coverage following completion of the IPO.

As a result of the Jumpstart Our Business Startups (“JOBS”) Act passed in 2012, companies contemplating an IPO can conduct “testing-the-waters” meetings (“TTW”) with qualified institutional buyers and other institutional accredited investors before publicly filing a registration statement. Such TTW meetings allow the company’s management team and underwriters to get feedback on the offering and their pitch to investors, which can be used later on in the actual roadshow. You should consult with your underwriters to determine whether TTW meetings or other forms of pre-deal investor education would be valuable. Companies should bear in mind that any materials used to test the waters may be requested by the SEC.

During this phase your counsel will also typically prepare and submit the company’s application to list on the relevant stock exchange, with the listing process thereafter proceeding in parallel with the SEC review process. Generally speaking, the stock exchange listing process is much less onerous than the SEC review process. The major stock exchanges compete vigorously for listings and are keen to make the listing process as efficient as it can be. Your counsel will also use this time to prepare amendments to the company’s organizational documents and plans and policies so that they are appropriate for a public company.

Your and the underwriters’ legal counsels will also prepare an underwriting agreement, which is the relatively standardized contract between the underwriters, the company and any selling stockholders whereby the underwriters actually agree to buy the stock being sold. The underwriting agreement is only executed at the time of the pricing of the offering following the conclusion of the roadshow. It’s an odd aspect of U.S. listings that a working group can work together for months and even years without any form of written agreement. It is only when the transaction actually prices that there is a contract between you and the underwriters setting out the parties’ respective obligations to sell and buy the stock.

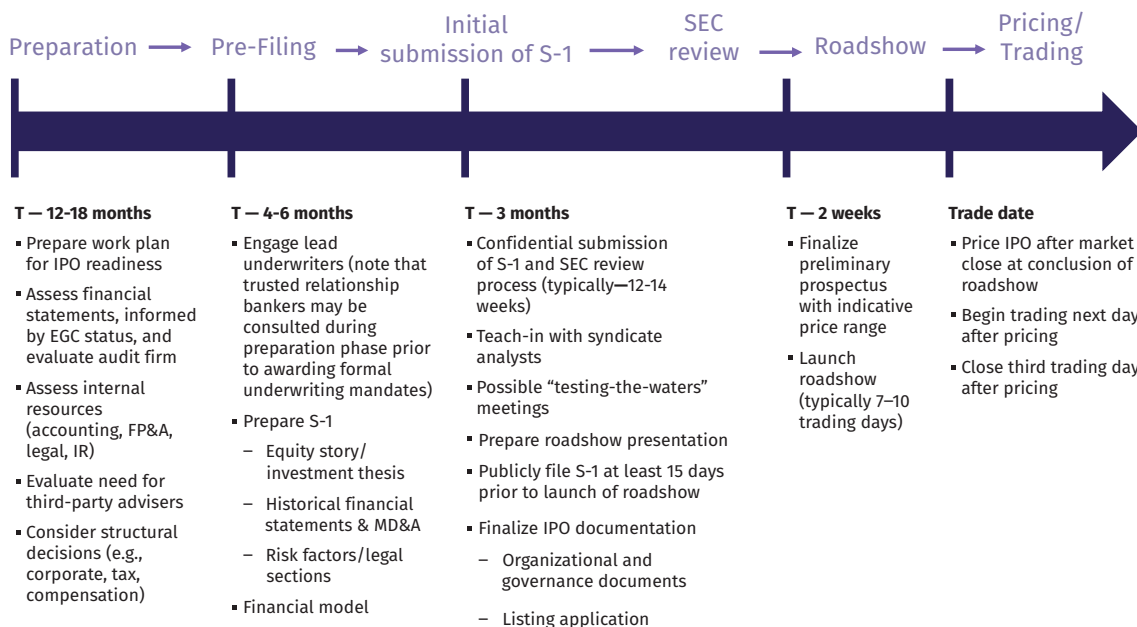
During this phase your auditors will also work with the underwriters’ counsel to prepare a “comfort letter” to support the underwriters’ due diligence investigation. A comfort letter is a letter that is delivered by your auditors to the underwriters (and typically also is addressed to the company and its board of directors) that confirms matters relating to the financial statements themselves and also addresses specified financial information that appears in the registration statement outside of the financial statements. So, for

example, a statement in the MD&A saying that your revenue increased 15% year-over-year wouldn't technically be "in" the financial statements but it is derived from them, and so the underwriters would get "comfort" from the auditors on the recalculation of the percentage change and that the underlying amounts agree back to the financial statements. Typically, two comfort letters are issued to the underwriters—one at the time the underwriting agreement is signed (generally the pricing date), and one (an updated letter or "bring-down letter") at the closing date.

**Marketing and pricing.** Once the company has largely (if not entirely) cleared the SEC staff comments, it is in a position to commence the active marketing of the IPO, which typically starts with meetings with the sales forces of the lead underwriting firms and is followed by a roadshow where company management (typically the CEO and the CFO and, if multiple roadshow teams will be deployed, other senior members of management), accompanied by the lead underwriters, meet with prospective investors in cities throughout the United States and also sometimes internationally. A recorded version of the roadshow presentation is also ordinarily made publicly available on specialized third-party websites that have bells and whistles that enable them to comply with the applicable SEC rules. As discussed further in Chapter VII (Marketing, Pricing and Distribution), it is worth noting the shift towards conducting virtual roadshows catalyzed by the coronavirus pandemic, has survived and has continued, in many circumstances, to permit roadshows to be completed in a more compressed timetable.



# Illustrative IPO Timeline



Note that if the company has availed itself of the ability to submit its registration statement to the SEC staff on a confidential basis, the registration statement must have been publicly filed at least 15 calendar days prior to the commencement of the roadshow. Typically, on the day that the roadshow concludes, your counsel arranges for the registration statement to be declared “effective” by the SEC and, after the market close on that date, the IPO will be priced and the company will enter into the underwriting agreement with the underwriters. On the following trading day the company’s stock will open for trading on the relevant stock exchange and your life as a public company will begin. Generally on the third trading day following the pricing, and the second trading day following the initial trading, the IPO will close, with the stock being delivered to the underwriters in exchange for the offering proceeds, net of underwriting discounts. Chapter VII (Marketing, Pricing and Distribution) describes in greater detail the process by which the company is valued and the stock is sold.

## B. What goes in the registration statement? What financial statements are required?

In the United States, the basic regulatory framework governing IPOs has been in place since the early 1930s, when Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934 (“Exchange Act”) in reaction to the stock market crash of 1929. The Securities Act and the Exchange Act to this day continue

to frame the process by which companies conduct public offerings of their securities and provide ongoing public reporting thereafter. The Securities Act requires a company to file a registration statement with the SEC, and have that registration statement be declared “effective” by the SEC, prior to publicly distributing its shares in the United States.

Far and away, the most common type of registration statement for an IPO in the United States is Form S-1. (While real estate investment trusts use Form S-11 and most foreign companies use an alternate form, the basic concepts are the same.) The applicable SEC form specifies the information that must be included in the registration statement and refers to specific SEC regulations (Regulation S-K and Regulation S-X) that provide instructions on what information must be presented and how. If your company qualifies as an EGC and/or smaller reporting company (or “SRC”), you will be able to benefit from reduced disclosure obligations in the IPO registration statement and in your subsequent ongoing SEC reporting. We highlight

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some of these benefits throughout this book.

**A “smaller reporting company” is any issuer that:**

- **has public float of less than \$250 million or**
- **has less than \$100 million in annual revenues and**
  - **no public float or**
  - **public float of less than \$700 million.**

You will almost certainly have looked at the IPO registration statements (or the “prospectus” that constitutes the most important part of these filings) and subsequent SEC reports of other public companies in your industry before having gotten so far as reading this book—and if you have not you

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are encouraged to do so! We will not go through in extensive detail the specific requirements for the content of the registration statement, but suffice it to say that the registration statement is intended to be a comprehensive document that gives investors a balanced view of the company. In addition to describing the terms of the offering itself, it includes financial statements and a discussion and analysis of the company’s results of operations and financial condition, a description of the company’s business, disclosure regarding the material risks relating to the company’s business and an investment in its stock and information relating to the company’s directors and executive officers and significant stockholders. Although the rules can be quite technical, you should assume that the registration statement will be required to disclose any dealings in which the company is a participant that also directly or indirectly involve any of its directors, officers or significant stockholders.

The SEC also has specific and sometimes complex rules regarding the content and age of the financial statements that must be presented in a registration statement. In a Form S-1 registration statement, a company must generally present:

- **Audited balance sheets** as of the end of the two most recent fiscal years. The latest audited financial statements cannot be more than one year and 45 days<sup>1</sup> old at the date the registration statement becomes effective.
- **Audited income statements, cash flows, and changes in shareholders' equity** for each of the past three fiscal years. EGCs and SRCs may present such information for two years only.

Audited Financial Statement Requirements	Form S-1	Form S-1 (for EGCs and SRCs)
Income statement	3 years	2 years
Balance sheet	2 years	2 years
Statement of cash flows	3 years	2 years
Statement of changes in shareholders' equity	3 years	2 years

- **Interim financial statements** are required if the fiscal year-end financial statements are more than 134 days old, except for third-quarter financial statements, which are timely in an IPO through the 45th day after the most recent fiscal year end. After the 45th day, audited financial statements for the most recently completed fiscal year must be included. This means that for a calendar year-end company, audited financial statements as of the most recently completed fiscal year must be included as of the first business day after February 14th. (This is the reason why there is typically a dead period for IPOs each year starting in the middle-of February until the second half of March.) Interim financial statements can be presented in a condensed format and generally are not audited. However, a review of the interim financial statements is typically performed by the company's independent auditors.

One question that is frequently asked is—"do I have to go back and audit 'Year A' for purposes of including it in the initial submission of the registration statement when the requirement to include 'Year A' is going to roll off due to the eventual inclusion of 'Year C' or 'Year D' prior to the registration statement actually being circulated to potential investors or becoming effective?" Happily, following passage by Congress of

<sup>1</sup> Note there are certain situations where SRCs may have up to one year and 90 days as opposed to one year and 45 days.

the FAST Act in 2015 and subsequent guidance from the SEC, EGCs and non-EGCs may confidentially submit draft IPO registration statements that omit annual and interim financial statements (and the related management discussion and analysis disclosure) that they reasonably believe will not be required to be presented separately at the time they launch their IPO, in the case of EGCs, and file publicly, in the case of non-EGCs.

In addition to the financial statements of the company itself, separate financial statements of businesses that the company has acquired or where the acquisition is probable may also be required in the registration statement if the acquisition rises to specified levels of “significance” to the company as measured by the SEC’s rules (S-X 1-02(w)). In May 2020, the SEC adopted amendments to these rules, which generally reduce the number of financial statement periods required for acquirees. These new rules were effective on January 1, 2021. Previously, up to three years of separate financial statements could be required, whereas now a maximum of two years is required, which can significantly reduce the burden for registrants that have grown inorganically. The SEC also revised its tests of significance in ways that generally have resulted in fewer acquisitions being deemed significant as compared with the previous rules. If required, these separate financial statements cover one or two years plus more recent interim periods, if applicable, depending on the “significance” of the acquisition and generally must also be SEC-compliant as to form and content, although the financial statements of a non-public entity need not include public company disclosures, such as segment information, certain disclosures about employers’ pensions and other postretirement benefits, and earnings per share. Acquiree financial statements do not need to be included in initial registration statements once the acquired business has been reflected in post-acquisition audited financial statements of an IPO registrant for a period of nine months or one year, depending on significance. The requirement to include separate financial statements of acquired and to be acquired businesses can be a major stumbling block in the IPO process, particularly where the acquired businesses do not have financial statements that have been audited. Accordingly, this is an area where close consultation with the company’s auditors and accounting advisors early in the process is crucial and recent acquisitions of any size should be evaluated. Given the significant timing and other hurdles that these requirements create, it is not at all uncommon for companies to freeze their acquisition activity in the run up to an IPO to avoid the challenges presented by the requirement to present acquired business financial statements.

In addition, the registration statement may be required to include the separate financial statements of significant equity investees of the company as of the same dates and for the same periods as the company’s financial statements. Individual years in these financial statements only need to be audited for periods in which the equity investment is “significant.”

Further, a company may be required to present financial information of the parent on a standalone basis in instances where restrictions (for example, regulatory capital requirements or covenants in debt agreements) prevent its subsidiaries from freely transferring funds or assets to the company. In practice, this information is commonly disclosed via an audited footnote to the consolidated financials.

The registration statement for an IPO may also be required to, and frequently does, contain “pro forma” financial statements or financial tables, with accompanying footnote disclosure, giving pro forma effect to certain transactions or events as if they had already occurred. While the need for pro forma financial information most obviously occurs in connection with significant business combinations or dispositions, the requirement can also arise in other circumstances if pro forma financial information would be material to investors. For example, the use of proceeds from the IPO to repay outstanding debt obligations, the payment of extraordinary dividends, a reorganization anticipated in conjunction with the IPO, the conversion of debt or preferred stock or other changes in capitalization may necessitate the presentation of pro forma financial information, as could other situations in which the company’s historical financial statements are not indicative of the ongoing entity.

Pro forma financial statements are required to include:

- **Balance Sheet:** Pro forma presentation should be based on the latest historical balance sheet included in the filing, and presented as if the transaction or transactions being given pro forma effect had occurred on the date of the balance sheet. A pro forma balance sheet is not required if the transaction being given pro forma effect is already reflected in the registrant’s historical balance sheet presented.
- **Income Statement:** Pro forma presentation should be based on the latest fiscal year and latest interim period (and, if you wish, the corresponding interim period from the prior year) included in the filing and presented as if the transaction or transactions being given pro forma effect had occurred on the first day of the earliest pro forma period presented.

The basic guidelines for pro forma adjustments require breaking out:

- “Transaction accounting adjustments” which reflect the application of the required accounting to the transaction (such as acquisition accounting);
- “Autonomous Entity Adjustments” which reflect the operations and financial position of the registrant as an autonomous entity if the registrant was previously part of another entity, such as a spin-off transaction in which the costs allocated to the entity do not reflect all of the expected costs of operating as a standalone public company; and

- Optional “Management Adjustments” which allow the registrant more flexibility to include more forward-looking information by depicting synergies and dis-synergies of the transaction—these are only presented in the notes to the pro forma financial statements. In practice, “Management Adjustments” are often excluded due to their uncertain nature unless the company believes such adjustments would enhance the readers’ understanding of pro forma effects of the transaction.

## C. How much does going public cost?

IPOs are expensive. It is frequently remarked that the dollars raised in a company’s IPO may be the most expensive capital it will ever raise. There are significant costs relating to the transaction itself, as well as incremental costs to operate as a public company going forward. The following chart provides a summary of the different types of costs associated with going public and being a public company:

## Going public

Directly attributable to the offering (reported as netted against gross proceeds)

- Underwriter discount, which based on public registration statements, results in fees equal to 3.5%-7% of gross proceeds for most average sized offerings
- Legal, accounting and printing fees associated with drafting the registration statement and comfort letter
- Roadshow expenses
- In addition to the underwriter discount, on average companies incur \$5.8 million of costs directly attributable to their IPO, though this can vary depending on the size and complexity of the company and the offering
- SEC filing and exchange listing fees

Other incremental organizational costs (expensed as incurred)

- Tax and legal entity restructuring costs in anticipation of the IPO
- Additional audit, interim/quarterly review costs, advisory accounting and other costs to make the financial statements S-X compliant
- Valuation reports
- Costs to draft new articles of incorporation, audit committee charter, by-laws and other agreements

## Being public

One-time costs to convert the organization to a public company (expensed as incurred)

- Costs to implement new financial reporting systems and processes
- Initial costs to document internal controls and comply with SOX
- Costs to identify and recruit a new board of directors
- Costs to implement new executive and employee compensation plans
- Based on PwC survey results, on average companies incur more than \$1 million of one-time costs to convert their organization to a public company

Recurring incremental costs of being a public company (expensed as incurred)

- Incremental internal staffing costs (accounting, tax, legal, human resources, technology, internal audit and investor relations)
- Professional fees for legal and accounting advice
- Public company Directors & Officers (“D&O”) insurance
- Based on PwC survey results, on average companies spend more than \$1 million on annually recurring costs as a result of being public

**Transaction-related costs.** The largest transaction cost is typically the underwriting discount (i.e., the difference between the amount the underwriters pay for the stock being sold and the initial public offering price at which they sell this stock to investors), which is borne by the company in a primary offering and typically borne by selling stockholders in a secondary offering where they are the ones receiving the proceeds. The underwriting discount is almost always calculated as a percentage of the gross proceeds and typically ranges from three and a half percent to seven percent but may be a lower percentage in the case of large offerings.

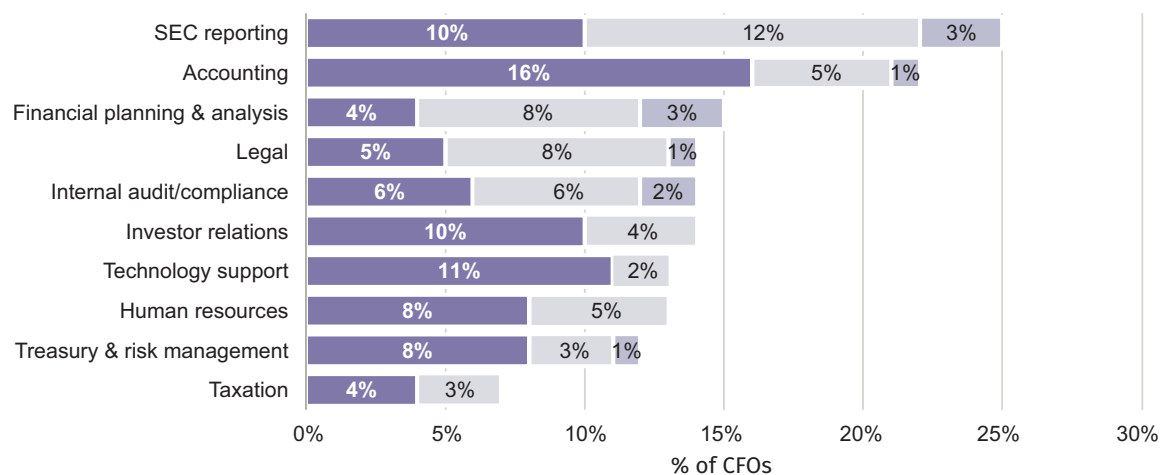
The most significant other offering expenses tend to be the cost of the company's outside counsel and other advisors (e.g., accounting advisor), the cost of its auditors and the cost of the financial printer. The company will also be required to pay a registration fee to the SEC, which is calculated based on the offering size and varies from year to year based on the funding requirements of the SEC, as well as fees to the relevant stock exchange. We note, however, that these non-underwriting discount transaction-related expenses typically range upwards from \$3 million in the aggregate and are frequently significantly higher. Offering costs also, perhaps unsurprisingly, tend to be higher for larger offerings and larger companies. In particular, legal and accounting costs, areas where larger companies may face additional complexities in preparing for an IPO, increase significantly for larger companies. Printing costs also trend upward for larger deals, likely as a result of larger filings and demands on printer resources. SEC registration fees also increase in proportion with increases in gross proceeds, but are a relatively minimal cost of an IPO.

***Incremental going forward costs.*** After the IPO, companies incur incremental expenses on an ongoing basis to be a public company, including expanded accounting, investor relations and legal capabilities, higher levels of professional fees for auditors, outside counsel and other advisers, annual stock exchange listing fees, as well as director fees and suitable directors and officers (“D&O”) insurance coverage, for which the premiums often can be a surprise to newly public companies.

Additional staff requirements account for a significant portion of the cost differential between public and private companies. Accounting, legal, financial planning and analysis, and internal audit and compliance departments within public companies often have to hire staff to acquire new capabilities, according to PwC's survey (see figure below). Other areas where newly public companies may need to hire people include investor relations, human resources, technology, tax, and treasury and risk management. While the actual costs incurred are highly dependent on the size and complexity of the company and the expertise of its existing personnel, it is clear that the costs of these additional hires can add up quickly.



## Number of New Staff Added in Each Functional Area Since Going Public



Source: PwC survey conducted by Oxford Economics

Number of staff added  
 ■ 1-2 ■ 3-4 ■ 5-10

### D. How do I select lead underwriters?

A private company that is viewed as an attractive IPO candidate is usually already being called on by coverage bankers at investment banking firms. Investment banks devote incredible resources to finding and cultivating pre-IPO companies. The idea being that if a company has a longstanding and close relationship with a particular banker and his or her firm, that may well be enough to ensure that bank a seat at the table for the IPO. But being the first doesn't necessarily mean being alone. In fact, it is not uncommon for even very small IPOs to have more than one lead underwriter, and this has become ubiquitous in large transactions. The idea from the company's perspective is that, since the banks will just share the gross spread, it won't cost you any more to add another bank (and it may in fact help you foster stronger ties to multiple banks and to their research analysts).

So how should you go about selecting these banks? Without wishing to be overly dramatic, the lead underwriters are highly significant to the ultimate success of the IPO. In addition to taking a guiding role in the overall process and, most importantly, actually selling the stock, they will provide insights into how investors will view the company and its industry and how the company should best be positioned, guide the company in crafting and communicating its investment thesis and structuring the offering, assess

investor demand and provide recommendations on valuation. Given this critical and multifaceted role, companies will often interview a number of banks before selecting the leads. In addition to considering the institutional and personal relationships they have with the banks and bankers and their reputations and track records in the sector, companies will focus intently on the quality and views of the banks' analysts, their familiarity with the company and its industry and their ideas for how the company can be best positioned to achieve a favorable valuation. You should also pay attention to the percentage of deals the lead manager launches that actually price. Finally, if the company has other financing or capital needs you should consider what institutions are able to be helpful in this area as well. For example, it may be possible for your company to refinance its bank debt or bonds in connection with the IPO or secure new or additional liquidity commitments.

It is becoming more common for companies pursuing an IPO to engage an objective capital markets advisor to assist with various aspects of its preparation and execution. In some cases, capital markets advisors will help with the overall equity story and investor positioning, key financial metrics and investor relations preparation and assist in benchmarking and advising on roles and economics to the underwriters. In other cases, capital markets advisors will further assist the company in interacting with the underwriters going forward, such as by participating in investor targeting and launch, pricing and allocation decisions. These advisors are typically boutiques that field experienced former equity capital markets ("ECM") professionals from the major investment banks who will tout their ability to redress the information asymmetry that can arise when the company's management team does not have experience dealing with the equity capital markets and their ability to help the company get more out of its investment banks. In addition to contributing their practical and technical expertise, capital markets advisors can also help mitigate concerns that the investment banks may prioritize the interests of their institutional investor clients over the interests of the company. ....

## **E. Do I need to switch my accounting firm?**

Although a somewhat awkward topic, the authors have found that CFOs of companies that are not already using one of the "Big Four" firms inevitably ask whether they need to switch accountants if they decide to pursue an IPO.

To start with, let us note that there are hundreds of audit firms that are registered with the Public Company Accounting Oversight Board and permitted to audit the financial statements of an SEC-registered company. But let us also say that year in and year out the Big Four firms audit more than 60% of all of the companies going public in the United States, a percentage which increases if you exclude very small transactions. If you add to these the next five or six major accounting firms in terms of IPO experience you will have

captured almost the entire IPO market. Simply put, the Big Four firms, plus a select handful of others, audit the vast majority of IPO companies. Guidance on the identification of potentially sensitive or problematic accounting issues, financial disclosure issues and the overall transparency of financial reporting is particularly important. If you have a desire to deviate from the norm here, you should first discuss with your underwriters as they may say that use of a lesser known auditor will adversely impact marketing as certain investors will simply choose to pass. In addition, a number of the bulge bracket investment banks will simply refuse to take a company public unless they are using an independent auditor that they believe has the requisite experience and expertise. Our own personal view is that it is well worth it to engage a firm that has the desirable depth of experience, and to bring them on board early enough that they can do at least one (if not all) of the years of audit that are required to be presented in the registration statement—often this audit can reveal financial reporting issues that must be resolved before the registration statement can be submitted to the SEC. (Although admittedly entirely self-serving to say, Josh and Will would also suggest that a similar analysis applies when considering whether to hire new legal counsel—the bottom line is that you will save time and reduce execution risk if you have lawyers in this role who do it for a living.)

One additional note on the use of an accounting advisory firm. The Sarbanes-Oxley Act, when passed in 2002, put in place a number of absolute rules relating to what an audit firm can and cannot do for a client and still be considered “independent.” A company may have a truly magnificent accounting team, but without SEC and transactional accounting experience they will struggle to do what is needed to get the company through the IPO process and beyond. As a result, it has become increasingly common for companies to seek transaction support and advisory services from a second accounting firm that is not restricted by professional and statutory independence standards. Among other things, an advisory accountant with significant relevant experience can provide project management, strategic advice, issue resolution, advice and assistance with complex financial reporting matters and the design, documentation and testing of internal controls over financial reporting, supporting accounting and finance staff, as well as post-transaction services such as implementation of new reporting protocols, etc. Further, use of an accounting advisory firm, especially early in the process, can enable management to devote more focus on the marketing phase of the IPO.

## **F. NYSE or Nasdaq?**

The vast majority of companies pursuing an IPO in the United States list their stock on either the New York Stock Exchange (“NYSE”) or the Nasdaq Stock Market (“Nasdaq”). Generally, the listing requirements of the two exchanges are quite similar. For example, the NYSE and Nasdaq both require that an IPO company satisfy certain earnings, income or market value tests and that the distribution meet minimum

parameters. Similarly, while each exchange has its own corporate governance requirements, these requirements, too, have converged over the years and are now fairly similar, except with respect to board diversity, as discussed in more detail in Chapter III (Planning Ahead—What Should I Be Thinking About Now?). Indeed, even the distinction of three versus four letter ticker symbols that used to identify a company's listing venue (four letters for Nasdaq versus three or fewer for the NYSE) have fallen by the wayside with ticker portability.

Given the convergence of the more concrete distinctions between the two exchanges and the fact that underwriters will typically say that there is no meaningful marketing impact on the IPO that will result from selecting one versus the other, many companies will meet with both exchanges prior to making a decision. The two exchanges also still do have somewhat different brands, with the NYSE associated more with blue chips and Nasdaq with the technology and life sciences sectors, although even here you have seen the NYSE recently attract high profile technology listings while the Nasdaq has attracted some old line brand name companies.

### III. Planning ahead—What should I be thinking about now?

As noted in Chapter II (Overview of the IPO Process), companies may take six, 12, 18 or even 24 or more months to prepare for their IPOs before formally engaging underwriters and kicking off the actual transaction. What are they doing during all this time? And, perhaps more to the point, what should you be doing now if you believe your company is a viable candidate to go public at some point in the near- or medium-term future?

#### A. Look at your company the way investors will

As discussed in Chapter VII (Marketing, Pricing and Distribution), every company that pursues an IPO is going to be compared by analysts and investors with other companies that are already public. As off-putting as this may be for the founders and leadership of a private company that is almost certainly wonderfully unique in many ways, it is a reality. And, rather than fight it, it makes sense to understand it and, to the maximum extent possible, use this knowledge to take the steps necessary to ensure that your company is positioned correctly.

Think about the different lines of business your company is in—what publicly traded companies are in these or similar areas? How do the research analysts and the investment community value these peers? What metrics are used to evaluate these peers' performance? Are there different peer sets, approaches to valuation, and/or multiples applied to your company's different business lines? By reading the analyst reports on potential peers, thinking about these questions and even taking the time to meet with investors and analysts, you can start to understand how your company will be viewed by analysts and investors.

Having done this work, step back and think about how your company looks when viewed in this way. Do you have the ability today to capture and report the metrics that the market is used to seeing for companies like yours? Are you able to isolate information about separate lines of business that are valued differently by the market? If not, is it appropriate to rework your internal and even external financial reporting to be able to do this? Effecting these types of changes in reporting can take time.

Having accessed the information that will allow you to view your own company like a public market analyst or investor, what does this data say? For example, if you want your company to be viewed as primarily belonging with, and valued like, a particular peer set—is that a true reflection of your company's business?

Everyone involved should want the company to be valued appropriately in its IPO. Even setting aside potential shareholder lawsuits attracted by a stock drop, there is perhaps nothing more painful for a company that has recently completed an IPO than being rerated downward by the market in post-IPO trading. Are there acquisitions or new products (or, conversely, dispositions or discontinuances) that are on the whiteboard that may make sense to accelerate during this pre-transaction phase in order to bolster the intended investment thesis? As another example, how do your company's results, whether in terms of top line growth or margins or otherwise, compare to the peer set? Do they differ materially and, if so, why? Are there strategic initiatives to undertake now to enhance your company's future relative performance as it will be measured by the market?

Although no one without a deep understanding of your business can predict what specific insights may be gained from going through the exercise of understanding how the market values potential peers and then viewing your own company through the same lens or lenses, it would be quite surprising if such an exercise fails to uncover areas where an investment of your time and attention, and perhaps even dollars, in advance of an IPO would yield attractive returns.

## **B. Prepare to be a public company**

Running a private company with a small number of shareholders or investors can be very different than operating a public company. Private companies usually lack a public company finance infrastructure, almost certainly will not have an investor relations capability and may require additional resources within their legal function. They may also need to expand or reconfigure their management team to ensure that they have senior officers with the skill set to interact with a public company board of directors and public company investors. More broadly, a company should take a cross-functional and holistic approach to preparing its management team and business units to begin acting and functioning as a public company, both internally and externally.

During the pre-transaction preparatory phase, you should make yourself aware of the public company requirements to which you will be subjected as part of and following the IPO, and particularly those related to finance and accounting (e.g., public company accounting, internal audit and financial modeling and forecasting) and then evaluate your internal capabilities to identify deficiencies. Some of the key questions to ask include:

- Do we currently have a repeatable monthly and quarterly close process? Do we have the ability to close our books accurately each quarter, and to review and report the results to the public on a timely basis and in accordance with SEC guidelines?
- Do we have a finance department with expertise in SEC accounting and reporting requirements?

As we will discuss more in the next chapter, many private companies looking to become public companies have inadequate skill sets within their finance departments and hire additional internal staff in connection with going public.

- Do we have a finance team comfortable preparing reliable forecasts and projections and able to analyze current period results for reporting purposes?
- Are our processes and controls adequately documented and tested? Do we have a plan to comply with Sarbanes-Oxley requirements?
- Does our technology infrastructure adequately support our compliance efforts?
- Overall, the common theme to these questions is for companies to consider how prepared they are to be a public company, not just to go public. Having performed this IPO readiness assessment, create—and then execute on—a realistic work plan that addresses internal gaps and details necessary internal staff hires. It can take many months to address areas of deficiency or weakness, and you should build into your plans the time and cost of evaluating and implementing policies, building the necessary infrastructure and making critical hires. Private companies often underestimate the time it takes to get ready to be a public company—a transformation that needs to take place before, not after, the IPO.

### C. Revisit risk with a public company mindset

Every company, whether public or private, makes risk management decisions every day. Whether consciously, such as by deciding to undertake an enterprise-wide risk assessment exercise, or unconsciously, such as by deciding not to approve the hire of that additional resource in the compliance function. One way or the other, your company has decided what balance to strike in terms of accepting and mitigating risk.

Undertaking an IPO alters a company's risk profile. First, and somewhat self-evidently, a company that has gone public is exposed to entirely new types of risk—SEC enforcement actions, insider trading scandals and stock drop lawsuits, for example. But somewhat less obviously, a company that becomes publicly traded is also likely to find that this changes the cost-benefit equation it has previously used in deciding the right levels of risk appetite and investment in risk mitigation.

To see why this may be the case, consider a private company that faces an unfortunate regulatory censure. This is obviously not good, and the company in this hypothetical may be required to pay a fine and potentially be subject to new limitations or constraints on its business as a result. But consider the same circumstances arising in respect of a company that is publicly traded. The publicly traded company may be required to disclose to all and sundry the unfortunate event and the fine and other sanctions, potentially

impairing its reputation or attracting adverse attention in ways that would not have otherwise been the case, increasing the level of distraction for management and even attracting class action lawsuits if the stock drops as a result of the disclosure or even drops around the same time as the disclosure for a totally unrelated reason. In 2022, 208 new securities class action lawsuits were filed in state and federal court, and over a broader time period, it has been estimated that, at any given time, approximately 5%-10% of U.S.-listed companies are subject to securities class action lawsuits. In any event, you can see how the costs to the company of a misstep may be higher following its IPO than would have been the case before.

For this reason, consider conducting a thoughtful assessment of your company's risk exposure during the pre-transaction preparatory phase and identify whether there are areas that should be tightened up. As just one example, has the company invested appropriately in cybersecurity? Indeed, putting aside the fact that post-IPO the cost to the company of a misstep can be meaningfully higher, it will make the IPO process itself go more smoothly if you have thoughtfully assessed the risks impacting your business and consciously decided on the appropriate level of investment in risk mitigation. It can be unpleasant for everyone involved if as part of the IPO due diligence process the company's management appears less than fully conversant with the risks to its business or unable to convincingly articulate its approach to addressing these. Indeed, investors themselves are increasingly focused on how well the companies they invest in manage risk.

## **D. Consider your tax and organizational structure**

Choosing the appropriate structure for an IPO can provide substantial benefits and drive value and efficiency. It is far beyond the scope of this book (or, indeed, any book) to discuss the countless factors that may impact which tax structure is the right one for you. What can be said is that it is sometimes more costly (and perhaps even impossible) to effect changes on the eve of an IPO rather than well in advance. For this reason, consider during the preparatory phase whether any significant restructuring will be desirable and, if so, whether any advantage to effecting this earlier in the process outweighs any associated disruption or risk of "buyer's remorse" in the event the IPO fails to occur as anticipated. Moreover, the adoption of a complex tax or organizational structure can lead to complex accounting, legal and presentational challenges and may introduce the need to take additional time to educate the SEC staff and the market. We cannot overemphasize the importance of evaluating your tax and organizational structure early in the going public process so that unnecessary costs and delays can be avoided.



## E. How many independent directors do I need to have and when? And what makes a director “independent” anyway?

The technical answer to the first question is “at least three—one at the time of the IPO, a second 90 days later and a third (and possibly even a few more) within a year, but it may be a good thing for marketing to have three identified at the time of the IPO itself.” The answer to the second question is “there are a lot of technical rules relating to relationships a potential director can or cannot have with the company, including relationships with companies that do business with the company, so ask your lawyer to vet these issues before asking a new director to join your board.” And the answer to the third, unasked, question is “it takes a long time to find good directors so even though you may not want to formally add them to the board until the IPO actually happens, you should at least start thinking about it now.” It is worth mentioning that, in addition to the independent director requirements, board diversity has become increasingly important. We will spend the next few pages going over this in a little more detail—but given the number of questions we get on this topic we thought it made sense to fly down to 3,000 feet or so before doing so. Those who are content with the takeaways should feel free to flip ahead since we captured them earlier in this paragraph.

***How many independents are needed and when.*** The general rule for both NYSE- and Nasdaq-listed companies is that a majority of their board must be “independent”, and they must have fully independent audit, compensation and nominating committees (although the Nasdaq does not require a separate nominating committee if this function is performed by a majority of the independent directors). However, both exchanges have a transition rule for IPO companies that requires that they have at least one independent director on each of the three requisite committees at the time of the listing, majority independent committees (i.e., at least two independent directors) within 90 days of the listing and only become fully compliant—with a majority independent board and fully independent committees (i.e., at least three independent directors)—within one year after listing.

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For purposes of the NYSE rules, a director qualifies as “independent” if the board of directors of the company has affirmatively determined that she or he has no material relationship, direct or indirect, with the company. In making this determination, the board of directors should broadly consider all of the relevant facts and circumstances surrounding a director’s relationships with the company from the standpoint of the director as well as that of persons or organizations with which the director has an affiliation. The NYSE rules preclude a director from being determined independent if the director or an immediate family member:

- is (or was in the last three fiscal years) an employee of the company (or, in the case of an immediate family member, an executive officer of the company);
  - received more than \$120,000 per any twelve-month period in the last three fiscal years in direct compensation from the company, other than in director and committee fees or pension or other deferred compensation for prior service (provided such compensation is not contingent in any way on continued service);
  - is a current partner or employee of the company’s internal or external auditor or was within the last three fiscal years a partner or employee of such firm and personally worked on the company’s audit within that time;
  - has an immediate family member who is a current partner of the company’s internal or external auditor or is a current employee of such a firm and personally works on the company’s audit, or who was within the last three fiscal years a partner or employee of such firm and personally worked on the company’s audit within that time;
  - is (or was in the last three fiscal years) an executive officer of a company that has a compensation committee on which any of the company’s present executive officers serves or served; or
  - is a current employee (or, in the case of an immediate family member, a current executive officer) of another company that makes payments to, or receives payments from, the company for property or services in an amount that exceeds (in any single fiscal year in the last three fiscal years) the greater of \$1 million or 2% of such other company’s consolidated gross revenues.
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All this being said about what the requirements are, it is standard operating procedure for underwriters to advise companies they are taking public that it is preferable to be able to disclose to the market at the time of the launch of the marketing for the IPO that the company will have a majority independent audit committee coming out of the gate. Accordingly, it is worth the investment of some time before and during the IPO process to identify at least two or three independent directors. The job of identifying and finding independent directors can be a difficult and time consuming one. In addition to the fact that an audit committee member must meet heightened independence requirements as described below, they must also be “financially literate” and at least one member of the audit committee needs to have real finance and accounting expertise (frequently a former public company CFO or partner of an accounting firm). Putting aside the technicalities, one of the independent directors is going to have to be able (and willing!) to serve as the chair of the audit committee, which is a tremendous (and we mean tremendous) amount of work. The audit committee has the critically important but unglamorous job of overseeing the company’s financial reporting. (Conversely, at least one of the authors has frequently mused that he would like to come back in his next life as a professional nominating committee member.) And all this is on top of the fact that you want individuals on your board who understand your industry, can add value by bringing useful skills and insights to bear and work constructively with the other board members and management. And, in addition to the

application of the specific policies regarding “overboarding” discussed below, it also helps if the other demands on their time are not so significant as to prevent them from devoting themselves appropriately to their board work.

**What makes a director “independent”?** The NYSE and Nasdaq both require that public companies that list with them have, with a few exceptions (such as for controlled companies), a majority of independent board members. While the exchanges still have some minor differences in how they define “independence,” these standards have converged to the extent that their material provisions are now substantially identical. Both exchanges require the board to determine that the director in question has no material relationship with the company that would jeopardize his or her ability to act independently. Note that the NYSE has stated that “as the concern is independence from management, [it] does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.” In addition to these “determination” requirements, both exchanges impose a number of bright line tests that bar a board from determining an individual to be independent—for example, the board member cannot have been an employee of the company within the past three years and cannot have received compensation from the company (excluding board fees) in excess of \$120,000 in any of the last three years. Similar prohibitions apply to the director’s immediate family members. The rules also limit how much business the company can do with the board member’s employer.

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For purposes of the Nasdaq rules, a director qualifies as “independent” if the board of directors has affirmatively determined that such director has no relationship with the company which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The Nasdaq rules preclude a director from being determined independent if the director or an immediate family member:

- is (or was in the last three fiscal years) an employee of the company (or, in the case of an immediate family member, an executive officer of the company);
  - accepted more than \$120,000 per any twelve-month period in the last three fiscal years in compensation from the company, other than in director and committee fees, compensation paid to a family member who is an employee (other than an executive officer) of the company or benefits under a tax-qualified retirement plan, or non-discretionary compensation;
  - is a current partner of the company’s outside auditor or was in the last three fiscal years a partner or employee of such firm and personally worked on the company’s audit;
  - is an executive officer of a company that has a compensation committee on which any of the company’s executive officers served at any time during the last three fiscal years; or
  - is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company has made, or from which the company has received, payments for property or services in the current year or any of the past three fiscal years, in an amount that exceeds the greater of 5% of the recipient’s consolidated gross revenues for a particular year or \$200,000, other than payments arising solely from investments in the company’s securities or payments under non-discretionary charitable contribution matching programs.
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To be independent for audit committee purposes, a committee member must meet the general NYSE or Nasdaq independence standards for directors described above and also the following additional SEC requirements for audit committee members. SEC rules define an “independent” director, for purposes of serving on an audit committee, as a director who, except in his or her capacity as a director or board committee member:

(1) does not accept directly or indirectly any consulting, advisory or other compensatory fee from the company or any of its subsidiaries; and

(2) is not an “affiliated person” of the company or any of its subsidiaries.

Direct or indirect acceptance of a compensatory fee by a director includes acceptance of such a fee by (1) a spouse, a minor child or stepchild or a child or stepchild sharing a home with the director or (2) an entity (a) in which the director is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and (b) that provides accounting, consulting, legal, investment banking or financial advisory services to the company or any of its subsidiaries.

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### ***Additional requirements for audit committee***

**members.** Audit committee members must qualify under an enhanced independence analysis that imposes additional, stricter independence standards above and beyond those outlined above. So while a board member can be “independent” for purposes of the rules requiring that a company have a majority of independent directors, even if they own a significant amount of the company’s stock or are affiliated with a controlling stockholder for example, the enhanced independence standards would preclude such an affiliated person of the company or any of its subsidiaries from qualifying as independent for purposes of serving on the audit committee. An audit committee member must also not be an “affiliated person” of the company or any of its subsidiaries. In addition, some proxy advisory firms establish limits on the number of audit committees a director can sit on and if a board member serves on more than three public audit committees the NYSE requires an affirmative determination (which is disclosed) that such service will not impair their ability to serve.

In addition to these enhanced independence standards, members of the audit committee must also satisfy the substantive standard that they are “financially literate” (as such qualification is determined by the board). Also, the NYSE requires that at least one member of the audit committee have “accounting or related financial management experience” while the Nasdaq requires that at least one member have “past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.” Under both sets of stock exchange rules, a director who qualifies as an “Audit Committee financial expert” (as defined by the SEC) is presumed to satisfy this financial sophistication requirement—public companies are required to disclose whether they have an “Audit Committee financial expert” and, if not, explain the reasons why not.

### **Additional requirements for compensation**

**committee members.** Both the NYSE and the NASDAQ require public companies to consider additional factors when evaluating the independence of compensation committee members. The board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to: (1) the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the company to such director; and (2) whether such director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

You might also consider constituting a compensation committee with directors who are “non-employee directors” for purposes of Rule 16b-3 under the Exchange Act, and thereby able to exempt equity awards to directors and officers from the short-swing profit recovery provisions of Section 16 of the Exchange Act.

**Board diversity.** Board diversity is currently a matter where the corporate governance requirements of the NASDAQ and the NYSE diverge. While the below can be of debate and of course subject to future change, currently the NASDAQ requires listed companies to disclose certain board diversity statistics pursuant to a standardized template and to have or explain why they do not have at least two diverse directors. The NYSE does not currently have any disclosure or other requirements related to board diversity. However, notwithstanding any legal or listing requirements, certain investors may expect board diversity.

## **F. Review related party transactions**

The SEC requires companies wishing to go public to include a separate section in their registration statement that details the company's transactions involving its related parties. The overarching disclosure rule is relatively simple: provide the details for any transaction in the last three years involving more than \$120,000 in which the company is a participant and any director, executive officer or 5% stockholder (or their immediate family members) had or has a direct or indirect material interest. The rule's complexity comes from its exceptions, which go on for several pages, but suffice it to say that if the company is a participant in a transaction that involves more than \$120,000 and in which a director or officer is also interested, even

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A “non-employee director” is a director who:

- is not currently an officer or employee of the issuer or a parent or subsidiary of the issuer;
  - does not receive compensation in excess of the amount that would be required to be disclosed under Item 404(a) of Regulation S-K (currently \$120,000), either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director; and
  - does not possess an interest in any other transaction for which disclosure would be required under Item 404(a) of Regulation S-K.
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indirectly, you will probably need to disclose it. In addition, even if related party transaction disclosure is not required, you may nonetheless need to disclose transactions involving your independent directors if these transactions are considered by the board in determining their independence.

With a few exceptions, SEC rules do not prohibit specific activities as long as these are disclosed to investors. If the arrangement looks unusual or off-market, it can garner negative public attention. Many companies decide that they would rather forego certain arrangements than have them disclosed in SEC filings and then picked up by the press or become the subject of water cooler conversation in the office. In addition, the existence of certain types of arrangements can also negatively affect the voting recommendations of proxy advisory firms.

However, some things are flat out prohibited whether you disclose them or not. In response to the accounting scandals of the early 2000s, Congress passed a law that prohibits public companies from extending credit, or arranging for the extension of credit, to their directors and executive officers. Previously, it had been quite common for public companies to lend money to their executive officers to either buy company stock or a home in a new city and these loans are still quite common for private companies. Then WorldCom lent its CEO, Bernie Ebbers, \$408 million to cover margin calls on loans against his WorldCom stock, which did not turn out to be a great investment after all, and the rest is history. One of the unexpected traps in preparing to go public relates to the timing of this prohibition. The limitations and restrictions to which public companies are subject typically begin to apply when the company actually sells its stock to public investors. This insider lending prohibition, by contrast, applies from the time of the first public filing of the registration statement. As a result, insider loans need to be cleaned up before you publicly file with the SEC.

During the preparatory phase, consider reviewing the transactions and arrangements your company has with management and stockholders and see whether these are compatible with your anticipated future public company disclosures. It may be that some level of disclosure in the IPO registration statement cannot be avoided, given that these disclosure requirements look back three years, but it may be more appealing to be able to say that they were wound up prior to the eve of the IPO. Also, it can frequently take time to unravel arrangements so giving all concerned some runway to do this can make it less painful.

## **G. Shareholder arrangements**

Another area that makes sense to focus on well in advance of an IPO is arrangements with and among the company's shareholders, to be sure that these are compatible with the IPO and being a public company. More specifically, it may make sense to take inventory of all shareholder arrangements to identify if there

are consent, participation or other rights shareholders have that may directly or indirectly impact the transaction timeline. This need not be an explicit right to consent to or to participate as a seller in an IPO— if a shareholder has the ability to block amendments to charter documents or corporate reorganizations, this may itself effectively give that shareholder the ability to hold up the transaction. Even soft items such as governance rights can pose a problem. For example, as discussed above, following an IPO a company’s board will be required to ultimately have at least three and possibly more independent directors, and it may not be consistent with the anticipated composition of the company’s post-IPO board to include designees of smaller shareholders who may have been granted the right to a seat on the board of the company as a private company. Depending on the dynamics, it can be tricky to request consents or take rights away from a stockholder on the eve of a transaction. As such, consider on a case-by-case basis if your company has afforded shareholders rights that could be problematic and whether it makes sense to revisit these arrangements in advance.

In addition, we note it is standard operating procedure in an IPO for the underwriters to seek to “lock up” all pre-IPO shareholders for a period of time following the date of the pricing of the IPO (typically 180 days). So called “lock-up letters” are agreements directly between the pre-IPO shareholders and the underwriters whereby the shareholders agree they won’t sell their shares, lend them, margin them or really do anything with them that involves putting money in the shareholders’ pockets or shifting away from them the economic consequences of ownership of the shares until the lock-up period has expired. Underwriters will frequently express an interest in locking up “all” of the pre-IPO shares if they can.

And while in our experience if this “lock up” is not practicable it need not be a show stopper, the underwriters do have a legitimate concern that it could impede the successful marketing of the offering if IPO investors are not able to be assured that there will not be a large volume of stock from pre-IPO holders being dumped into the market shortly after trading starts. Accordingly, in anticipation of making the IPO process run more smoothly, you may wish to consider whether your arrangements with existing shareholders, including employee shareholders, can be designed in such a way that they will prevent these holders from selling during the anticipated IPO lock-up period and even require them to enter into customary lock-up letters directly with the underwriters.

## H. Anti-takeover protections

It is worth considering whether to implement “anti-takeover” protections at the time of an IPO that will impede hostile acquirers who may seek to gain control of your company without negotiating with your board. Given that investors may suspect that management is attempting to use such protections to entrench its own position at the expense of shareholders, a company should be thoughtful about its

approach to such protections. Such protections could also affect a public company's eligibility for inclusion in certain stock indices.

A number of devices and protections are available to IPO issuers. The most straightforward, and powerful, anti-takeover protection seen with some level of frequency (particularly in specific industries) is a dual-class high vote/low vote structure, which affords the holders of a high vote class of stock (typically founders, family owners, selected pre-IPO owners or insiders) with voting power sufficient to control the election of directors even when public investors, who hold a separate low vote class of stock, own a majority of the economic interests in the company. While the precise percentage varies significantly from year to year depending in part on market conditions and the nature of the companies going public during that market window, upwards of a quarter of newly public companies in some years may employ disparate voting capital structures. In response to investor preferences, however, a growing proportion of these companies have begun to build in time-based sunsets on these arrangements. In recognition of the prevalence of these multiple class capital structures, following a consultation with market participants that commenced in late 2022, S&P Dow Jones Indices announced in April 2023 that it was reversing a policy adopted in 2017 and will again permit companies with multiple share class structures within the S&P Composite 1500 Index and its component indices. FTSE Russell still excludes companies from its indices if their "unrestricted public shareholders" do not hold at least 5% of the voting power.

Another such device is a "classified board", which is a board of directors divided into multiple classes (almost always three), each of which serves a staggered multi-year term (almost always three years), which prevents a hostile acquirer from replacing more than a specified percentage (almost always one-third) of the directors at any single annual meeting. The prospect of having to conduct successful proxy fights at two successive annual meetings in order to gain control of a company's board can in and of itself be a significant deterrent to a hostile bidder. In contrast to the use of a high vote/low vote structure, which remains less common outside of specific industries and can attract investor resistance, the significant majority of IPO issuers have classified boards. For example, based on a survey of certain of the largest IPOs by deal size between July 2020 and September 2022, over 90% of companies going public implemented a classified board. However, among larger publicly traded companies it has become increasingly rare for this board structure to be retained over the long-term in the face of high levels of support from shareholders for proposals to declassify boards. For example in 2020, only approximately 10% of S&P 500 companies had a classified board. As with high vote/low vote structures, proxy advisory firms generally disfavor classified boards absent a reasonable time-based sunset provision (often 3-5 years).

There are also a welter of additional measures that are nearly universally implemented without significant investor resistance. For example, an IPO issuer's certificate of incorporation typically prohibits stockholder



action by written consent, which prevents a majority of the shareholders of the company from taking pre-emptive, unilateral action in lieu of a meeting. The certificate will also typically be drafted to include provisions restricting stockholders' ability to call a special stockholders' meeting, thus further inhibiting their ability to take extraordinary action. A company's bylaws will also almost always require timely advance notice to the company from stockholders before such stockholders may nominate new directors or propose other matters for consideration at a shareholders' meeting. A supermajority of shareholders' votes may also be required in order to amend the company's certificate of incorporation or bylaws. As with classified boards, supermajority voting requirements and certain other of these measures have become less common among larger, seasoned public companies.

It is also almost universal for IPO issuers to authorize in their certificate of incorporation what is referred to as "blank check" preferred stock, which enables a board to create and issue new series of preferred stock with whatever rights and preferences the board may desire at a given time. The board may use this ability to take certain anti-takeover actions, including the implementation of a stockholder rights plan, or "poison pill", without further stockholder approval. A poison pill generally allows stockholders to purchase a company's common stock at a highly discounted price if a large block of stock is acquired by a third-party who has not been pre-approved by the board, the effect of which is to dilute the third-party's value. Poison pills are extremely rare in IPO issuers due to the negative reaction they tend to engender among investors and the fact that with the authorization of blank check preferred stock the board may deploy a poison pill later when needed.

You should also be aware that unless you take affirmative action to opt out, Delaware's anti-takeover statute (section 203 of the Delaware General Corporation Law) will apply to companies incorporated in that state (which is the jurisdiction of most publicly traded U.S. companies). This statute provides that, subject to certain exceptions specified in the law, a publicly held Delaware corporation may not engage in certain "business combinations" with any "interested stockholder" for three years after the date of the transaction in which the person became an interested stockholder. These provisions generally prohibit or delay the accomplishment of mergers, assets or stock sales or other takeover or change-in-control attempts that are not approved by a company's board of directors. Other states have adopted similar statutes. Some IPO issuers, such as companies controlled by financial sponsors, typically opt out of these anti-takeover statutes to avoid impeding the sponsors' ability to sell off its stake following the IPO.

## I. Management incentive arrangements

Companies going public often revisit the arrangements they are employing to incentivize management and their employees more broadly. Indeed, the ability to use publicly traded equity as a compensation currency

is frequently viewed as a key benefit of pursuing an IPO. There are various types of management incentive arrangements that might be established in connection with an IPO, which broadly fall into two categories: (1) stock-based arrangements, in which value is tied to the company's stock price, subject to specified vesting requirements, which are often only subject to continued service with the company; and (2) performance-based compensation arrangements, in which value is subject to the achievement of preestablished performance goals, which may include stock price and/or other company financial metrics as a measure of performance. Of course, frequently arrangements are structured that have characteristics of both stock-based arrangements and performance-based compensation arrangements, such as restricted shares, restricted units or stock options that vest upon achieving specified performance goals. In structuring management incentive arrangements, it is important to take into account potential tax, securities law and accounting issues such as (1) potential limitations on the deductibility of compensation in excess of \$1 million under Internal Revenue Code Section 162(m), (2) reporting and short-swing profit rules applicable to officers, directors and 10% beneficial owners of public companies under Section 16 of the Exchange Act, and (3) potential earnings charges associated with performance-based compensation and certain types of stock-based awards. There are also various types of broad-based employee arrangements that might be established once the company is public, such as an employee stock purchase program.

In addition, in connection with a potential IPO, consideration is commonly given to (1) entering into employment and noncompete agreements with key members of the senior management team; (2) reassessing, potentially with the assistance of a compensation consultant, the appropriate mix of salary, bonus, benefits, perquisites and company stock incentives offered to senior management, relative to other peer group public companies in similar industries; and (3) the impact of an IPO on the financial and estate planning of senior executives and substantial equity holders. Consideration should also be given as to whether any modifications to the company's existing compensation and employment arrangements may be necessary in order to comply with applicable tax and securities law requirements or that may otherwise be appropriate once the company is public.

## IV. Building a public company finance organization

The first few quarters of life as a public company are critical. There is uncertainty among investors and analysts because the company is relatively unknown and the consequences of not meeting expectations can be severe. The newly established public company is also unfamiliar with communicating with the investment community about its results and performance. An inability to communicate effectively with analysts and investors to manage expectations in those first few quarters can be damaging to shareholder value and compromise credibility.

As a result, getting the right finance organization, with the right capabilities to deliver quality financial reporting at the right time, is an important factor to a successful IPO and to being public. Finance staff and systems must be prepared to meet the needs and requirements of new external stakeholders, including higher expectations of transparency and data reliability, increased scrutiny of budgets and projections and demands for accelerated filing. This is typically achieved by first focusing on reducing the monthly financial close to a reasonable amount of time for a public company and then preparing the quarterly financial information in a timely manner and with the level of detail and accuracy that is expected of a public company. Enabling the finance organization with mature processes and technology will help to ensure that finance resources are able to provide value-added analysis rather than simply gathering data.

While accounting and financial reporting issues are often one of the more challenging and time-consuming areas, they can be the mere tip of the iceberg in terms of IPO preparation. The IPO process is cross-functional and companies must focus holistically on their preparations for going public as well as being public. A good IPO plan will identify the critical aspects of the finance function that need to be in place before starting the IPO preparation process, such as the CFO and controllership functions. Others, such as SEC reporting, can be built up during the IPO preparation process, initially relying on external resources and migrating the SEC and external

reporting functions to internal personnel as the IPO launch date approaches. The key is getting the appropriate resources in place at the right time without over-investing in making changes before the IPO is certain.

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### Questions to ask about your finance organization:

- Will we have the time and capacity to focus on ongoing operations and marketing the IPO?
  - Are there any data gaps in the financial information?
  - Do we have sufficient technical accounting expertise to handle the additional external reporting requirements?
  - Do we have sufficient documentation and policies to support external audits?
  - Does sufficient reporting exist to form the basis for management's discussion and analysis ("MD&A") and the business section?
  - Have we identified the accounting implications of any changes to the legal entity structures that may occur prior to the IPO?
  - Is our closing process sufficient to support our organization as a public company?
  - Can we provide the right information at the right time to investors, regulators, and management?
  - Can we accurately forecast and meet budget?
  - Are our budgets and forecasts available in a timely manner?
-

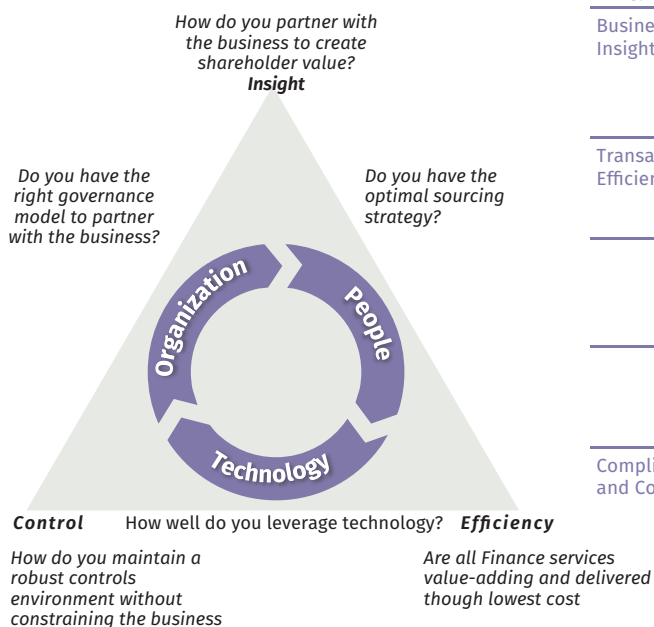
## A. What is uniquely different for public company finance functions?

Running a public company finance organization is a delicate balancing act that involves three core roles:

- delivering business insights—provide proactive, insightful decision support;
- maintaining compliance and controls—manage risk and ensure regulatory and control compliance; and
- achieving transaction efficiency—provide efficient transaction processing and reporting.

## Finance Process Framework

### PwC Framework for Finance



Source: PwC

While the overall responsibilities of the finance organization are largely the same for private and public companies, the specifics will differ, as will the skill sets required to fulfill them. In preparing for the transition, you will need to pay particular attention to the following areas:

- record to report process;
- financial planning and analysis;
- finance structure;

### Finance Processes

<b>Business Insight</b>	<b>Strategy to Execution (S2E)</b>	<ul style="list-style-type: none"> <li>▪ Strategic Planning</li> <li>▪ Target Setting</li> <li>▪ Budget and Forecasting</li> <li>▪ Business Analysis &amp; Reporting</li> </ul>
<b>Transaction Efficiency</b>	<b>Purchase to Pay (P2P)</b>	<ul style="list-style-type: none"> <li>▪ Procurement/Purchasing</li> <li>▪ Accounts Payable &amp; Outgoing Payments (incl. T&amp;E Accounting)</li> </ul>
	<b>Order to Cash (O2C)</b>	<ul style="list-style-type: none"> <li>▪ Credit Management</li> <li>▪ Customer Billing</li> <li>▪ Accounts Receivable &amp; Incoming Payments</li> </ul>
	<b>Record to Report (R2R)</b>	<ul style="list-style-type: none"> <li>▪ General Accounting &amp; Sub-ledger Close</li> <li>▪ C/L Close &amp; Consolidation</li> <li>▪ Reporting &amp; Analysis</li> </ul>
<b>Compliance and Control</b>	<b>Risk, Compliance &amp; Control</b>	<ul style="list-style-type: none"> <li>▪ Treasury</li> <li>▪ Corporate Tax</li> <li>▪ Risk Management</li> <li>▪ Internal Control</li> <li>▪ Investor Relations</li> </ul>

- finance processes and controls;
- finance systems; and
- finance talent.

We will now explore each of these areas in greater detail.

## **B. Record to report process**

The most significant change for many companies is the need to close and publicly report their financial results on a rigorous timeline. See Chapter VIII (Life as a Public Company) for a discussion of the filing deadlines for a public company's ongoing periodic reports. The inability to meet these requirements can shake investor confidence and potentially prohibit the company from completing capital market transactions while out of compliance. For most private companies, these are changes that take some time to implement.

Common closing and reporting issues for pre-IPO companies include:

- inability to gather data from different business units in a timely fashion;
- poor quality of financial reporting data;
- policies and procedures are inadequate, poorly documented, or not documented at all;
- no formalized process for preparing month-end results;
- overreliance on manual consolidation;
- ongoing need for late adjustments and corrections; and
- lack of resources or inadequate skill sets within the finance department, including lack of public company accounting and reporting expertise.

Most companies will need to dramatically accelerate the closing and reporting cycle once they go public, eliminating bottlenecks and waste, simplifying and standardizing processes, sequencing dependent activities, focusing on control and accountability, analyzing and eliminating post-close adjustments, and ensuring first-time accuracy.

In our experience, companies with successful five-day close processes achieve milestones within the following timeframe, using a series of common practices:

**Streamline, simplify and standardize processes with a focus on control, accountability and first-time accuracy.**

Close and Consolidation		
Leading Practices		Common Solutions
Milestone	Work Day <sup>1</sup>	
Payroll/AP/fixed assets	-1	<ul style="list-style-type: none"> <li>Intelligent use of accruals and estimates</li> </ul>
Inter-company processing	-1	<ul style="list-style-type: none"> <li>Proactive issue resolution and error correction</li> </ul>
Data submission & validation	-1	<ul style="list-style-type: none"> <li>Streamline transaction processes</li> </ul>
SG&A accruals	1	<ul style="list-style-type: none"> <li>Automate or eliminate manual entries</li> </ul>
Accounts receivable	1-2	<ul style="list-style-type: none"> <li>Eliminate non-value-added activities</li> </ul>
Revenue recognition	2-3	<ul style="list-style-type: none"> <li>Automate reconciliations</li> </ul>
Operational costs allocation	2-3	<ul style="list-style-type: none"> <li>Eliminate duplicate data entry</li> </ul>
Division sub-ledger close	2-3	<ul style="list-style-type: none"> <li>Utilize materiality thresholds</li> </ul>
Flash reporting	2-4	<ul style="list-style-type: none"> <li>Distribute workload away from period-end</li> </ul>
Tax provision	3-4	<ul style="list-style-type: none"> <li>Establish governance structure to enforce deadlines and improve accountability</li> </ul>
Corporate ledger close	3-4	<ul style="list-style-type: none"> <li>Publish the closing calendar and track status</li> </ul>
Consolidation (including eliminations & currency translation) activities	4-5	<ul style="list-style-type: none"> <li>Cross-train finance personnel</li> </ul>
Analytic review	5	<ul style="list-style-type: none"> <li>Provide clear and regular communication</li> </ul>
Management reporting	6-7	<ul style="list-style-type: none"> <li>Implement culture of continuous process improvement</li> <li>Leverage consolidation tools to automate eliminations, currency translation, top-side adjustments and data capture/promotion</li> <li>Run consolidations daily to facilitate flash reporting and support early error identification</li> </ul>

<sup>1</sup> Leading practice based on PwC experience with successful 5 Day closes at large multi-national companies using legacy financial systems. Source: PwC

**Eliminate duplication of effort and non-value-added activities that do not directly support external reporting requirements or provide effective decision support.**

Close and Consolidation		
Leading Practices		Common Solutions
Milestone	Work Day <sup>1</sup>	
10-Q Draft (w/out final numbers)	-5	• Validate reporting requirements, stakeholder needs and the underlying data structure
Variance analysis	5-8	• Automate roll forward analysis and the preparation of cash flow statements
Compile supplemental data	10	• Automate the collection of support material through supplemental accounts
Disclosures and MD&A	13-15	• Standardize monthly variance analysis to identify key business drivers & support MD&A
Sub-certification	17-19	• Utilize a controller’s questionnaire to identify disclosures and support sub-certifications
Disclosure review committee	20-22	• Leverage reporting tools to automate and standardize segment, regional, legal entity, tax and other internal and external reports
Earnings release	18-20	
SEC filing	24-28	

<sup>1</sup> Leading practice based on PwC experience with successful 5 Day closes at large multi-national companies using legacy financial systems.  
Source: PwC

Most companies do become more efficient in closing and reporting once they become public as they add resources and standardize processes. For example, a PwC survey reported that pre-IPO, 79% of companies took more than 10 calendar days to close a quarter, and 67% were taking more than 16 days. Once public, 77% took more than 10 days and just 36% needed more than 16 days. Streamlining the record-to-report process through automation and standardized procedures will free up much-needed staff for other activities.

### C. Financial planning and analysis

Financial planning and analysis, or “FP&A”, includes budgeting/forecasting, target setting and strategic planning, capital investment and risk analysis, and performance measurement.

Budgeting and forecasting, in particular, will become an increasingly important task in your life as a public company. Research analysts rely on this information, and a public company’s ability to meet its own earnings estimates and “The Street’s” estimates has a significant impact on its stock performance. Accurate

budgeting and forecasting is critical for a successful IPO and for the ongoing life of a public company. Therefore, it is paramount that the company has a well-functioning FP&A team. The FP&A team is responsible for developing realistic budgets and forecasts and must be able to articulate why variances have occurred.

Common FP&A issues for pre-IPO companies include:

- organizational silos that get in the way of collaboration;
- lack of standardized/consistent processes;
- lack of consistent metrics and reports to analyze business results;
- poorly defined budgeting and forecasting materiality levels;
- lengthy budgeting and forecasting cycle time;
- disconnect between strategic plan and operational plan;
- too many people involved in budgeting/forecasting processes;
- limited ability to perform scenario modeling/what-if analysis;
- disintegrated balance sheet and income statement planning; and
- lack of common terminology and hierarchies.



Companies with high-performing FP&A functions often exhibit the following capabilities:

Strategic Planning/ Target-Setting	Capital Investment & Risk Analysis	Budgeting, Forecasting, and Analysis	Value-Based/Performance Measurement
<ul style="list-style-type: none"> <li>• Determines critical success factors/ value drivers and aligns them with the organization's vision and strategic objectives</li> <li>• Creates joint responsibility between strategic planning and FP&amp;A for the integrity and analysis that supports the strategic plan</li> <li>• Establishes realistic targets for budgeting and forecasting processes; sets targets for key measures of accountability</li> <li>• Mitigates the impact of market and operational risk</li> </ul>	<ul style="list-style-type: none"> <li>• Evaluates capital investment, special projects, and market risk</li> <li>• Analyzes risk scenarios and exposures via modeling, monitoring, and external research</li> <li>• Enables more effective capital allocation and allocation of resources to balance risk appropriately</li> <li>• Evaluates return on investment and results of specific organizational endeavors against the risk involved</li> </ul>	<ul style="list-style-type: none"> <li>• Drives planning activities and processes and supports audits/ performance reviews</li> <li>• Creates responsibility for integrity of reported results and internal management reports</li> <li>• Supports functions related to the investment community (e.g., investor relations, board of directors, etc.), divisions, products, and customer segments as they relate to profitability reporting</li> </ul>	<ul style="list-style-type: none"> <li>• Conducts shareholder value analysis, identifying where value is being created or destroyed</li> <li>• Ensures value-based analysis and monitoring of risk is being used to evaluate current business, new products, and M&amp;A opportunities</li> <li>• Drives performance management (e.g., business intelligence and scorecards) and analytics process across the entire corporation</li> <li>• Monitor key measures of business performance</li> </ul>

Source: PwC

## D. Finance structure

You may need to make adjustments to the structure of your finance organization in order to streamline processes and increase efficiency, particularly in the external reporting and controllership areas. For transactional-type processes, many high-functioning public finance organizations have adopted shared-services models that centralize these activities internally or with an outsourced third party. Compliance and control activities are also best addressed through centralization so that they can be managed by people with deep functional knowledge of the area.

Activities that involve support for business decisions such as investments, new business ventures, new products, or other general management decisions may call for a more distributed finance organization model in which finance professionals are co-located in the businesses where these decisions are made. The following table depicts the three core roles of the finance organization and the common practices we see public companies follow to structure the organization.

### Common Practices of Public Company Finance Organizations

	<b>Insight</b> Provide proactive, insightful decision support	<b>Compliance and Control</b> Manage risk and ensure regulatory and control compliance	<b>Transaction Processing</b> Provide efficient transaction processing and reporting
<b>Organization Structure</b>	<ul style="list-style-type: none"> <li>Organized “By Customer”</li> <li>Centralized governance</li> <li>Direct line to Finance and dotted line to business units</li> <li>Single contact for customer</li> </ul>	<ul style="list-style-type: none"> <li>Organized “By Product or Service”</li> <li>Senior level reporting relationships</li> <li>Small groups, flat span of control</li> <li>Deep functional knowledge</li> </ul>	<ul style="list-style-type: none"> <li>Organized “By Activity”</li> <li>Economies of scale through centralization or shared services</li> <li>Outsourcing when further savings available and control not sacrificed</li> </ul>
<b>Process</b>	<ul style="list-style-type: none"> <li>Customized analysis to satisfy customer needs</li> <li>Standardized and integrated planning and forecasting</li> <li>Standardized metrics and reporting</li> </ul>	<ul style="list-style-type: none"> <li>Structured recurring compliance activities</li> <li>Other value-added activities are more flexible</li> <li>Involves a high degree of analysis</li> </ul>	<ul style="list-style-type: none"> <li>Highly standardized</li> <li>Highly automated</li> <li>Continuous improvement program</li> </ul>

	<b>Insight</b>	<b>Compliance and Control</b>	<b>Transaction Processing</b>
<b>People</b>	<ul style="list-style-type: none"> <li>• Highly skilled in financial analysis</li> <li>• Deep business knowledge</li> <li>• Strong interpersonal skills</li> <li>• Rotated throughout company</li> <li>• Ongoing training to stay current on the industry and analysis tools</li> </ul>	<ul style="list-style-type: none"> <li>• Deep functional knowledge</li> <li>• Ongoing training to stay current in area of specialization</li> <li>• Source additional expertise when not a core competency</li> </ul>	<ul style="list-style-type: none"> <li>• Non-automated activities performed by lower-skilled employees</li> <li>• Continuous improvement mindset</li> <li>• Possible high span of control</li> <li>• Highly cross-trained</li> </ul>
<b>Technology</b>	<ul style="list-style-type: none"> <li>• Automates standard reporting</li> <li>• Supports ad hoc analysis</li> <li>• Performs scenario planning</li> <li>• Integrated financial systems</li> <li>• EPM software to streamline FP&amp;A processes and solidify KPI/metric generation</li> </ul>	<ul style="list-style-type: none"> <li>• Specialty data and analysis</li> <li>• Perform scenario planning</li> <li>• Integrates with overall financial systems</li> </ul>	<ul style="list-style-type: none"> <li>• Automation of high volumes of transactions using core ERP functionality and/or automation tools</li> <li>• Automated, built-in controls</li> <li>• Self-service functionality</li> <li>• Specific tools to facilitate an efficient close process through tracking &amp; routing</li> <li>• Integrated account reconciliation solutions</li> </ul>

Source: PwC

## E. Finance processes and controls

Good internal controls are no longer just best practice. Section 404 of Sarbanes-Oxley requires that public companies have in place an internal control framework to prevent and/or detect material misstatements to the financial statements. This control framework should include documentation of the controls, associated policies, and procedures that contribute to the control framework and documentation, which can be relied on as part of a validation procedure to ensure that the controls are operating as designed.

Sarbanes-Oxley also requires the CEO and CFO to certify in each annual report on Form 10-K and quarterly report on Form 10-Q that:

- the report (10-K or 10-Q) neither contains any untrue statement of a material fact nor omits to state a material fact;
- the financial statements and other information in the report fairly present, in all material respects, the company's financial condition and results of operations;
- disclosure controls and procedures are established and maintained;
- certain disclosures about the company's internal control over financial reporting have been made to the issuer's auditors and the audit committee, including disclosures about significant deficiencies, material weaknesses, and any fraud;
- the report includes information about their conclusion on the effectiveness of disclosure controls and procedures and whether there have been changes in internal control over financial reporting during the most recent period; and
- the report fully complies with the Exchange Act.

## F. Finance systems

You cannot run a public company on the back of Excel spreadsheets. Most companies heading into an IPO spend considerable time and resources upgrading their finance IT infrastructure. Specifically, you will need to ensure that your systems and processes are documented and tested to comply with Sarbanes-Oxley requirements and that your technology infrastructure adequately supports compliance efforts. To accomplish this, many companies implement an ERP system ahead of the IPO. The accelerated financial reporting requirements and increased investor relations demands of newly public companies reinforce the need for a strong technology environment. KPI's & non-GAAP measures will need to be defined and communicated while preparing for an IPO. It is recommended to support this process and underlying data with EPM (Enterprise Performance Management) tools for repeatability and reliability.

You will also need to submit XBRL-formatted financial statements and financial statement schedules in an "XBRL Exhibit" for annual and quarterly filings and certain registration statements (in addition to posting the XBRL Exhibit on your corporate website). See Chapter VIII (Life as a Public Company) for additional information regarding XBRL-formatted financial statements and financial statement schedules. In 2020, one SEC Commissioner suggested that the SEC should consider additional opportunities for XBRL tagging, such as in proxy-voting disclosures.

Issuers are required to tag the following:

- each significant accounting policy within the significant accounting policies footnote tagged as a single block of text;
- each table within each footnote and schedule tagged as a separate block of text; and
- each quantitative amount (i.e., monetary value, percentage, and number) separately tagged within each footnote and schedule.

## G. Finance talent

Public company reporting requirements often require organizations to add and retain employees who possess skill sets a private company does not typically have. For example, 50% of newly public companies participating in a PwC survey hired new staff members specifically to increase their SEC reporting capabilities.

Other areas where companies typically need to add staff include accounting, legal, financial planning and analysis, and internal audit and compliance, as well as investor relations, human resources, technology, taxation, and treasury and risk management.

Common talent issues for pre-IPO companies include:

- knowledge gaps in the area of external reporting, FP&A, and tax;
- accounting organization focused primarily on transaction processing (e.g., AP, AR, monthly close) at the exclusion of other critical areas, such as forecasting, delivering business insights, or control and risk management;
- poor understanding of operational reasons for finance variances;
- significant number of post-close adjustments (e.g., due to lack of adequate review processes and teams); and
- challenges meeting earnings release, quarter-end, and tax compliance timelines.

Specific areas where you may need to add staff to your finance organization include:

**SEC financial reporting:** A typical SEC financial reporting team includes a director of SEC financial reporting and additional personnel commensurate with the size and complexity of the company and its financial reporting objectives. Your existing accounting and financial reporting team may need to hire additional

personnel to handle the incremental annual and quarterly reporting requirements and the compressed timeline for completing these tasks. Companies frequently establish a disclosure committee that reports to the CEO/CFO and has responsibility for ensuring timely compliance with disclosure and financial reporting obligations and proper implementation of a company's disclosure controls and procedures.

**Taxation:** Once you become public, there will be more emphasis on your income tax provision and tax planning strategies; therefore, it is common to increase the size of the taxation team. A typical taxation team includes a tax director, one or more tax managers, and additional personnel commensurate with the size and complexity of the company.

The taxation group is typically responsible for ensuring compliance with all federal, state, and international tax requirements, as well as compliance with indirect taxes including sales/use taxes, property taxes, and value-added taxes. In addition, a public company's taxation group is subject to shorter quarter and year-end close cycles, specific interim reporting rules that govern the quarterly tax provision preparation process, and more robust disclosure requirements for year-end reporting.

Furthermore, your overall tax planning function will become increasingly important. Effective tax planning is essential as it will drive enhancements in shareholder value through management of your effective tax rate and its impact on earnings per share ("EPS").

**Internal audit:** NYSE-listed companies are required to establish an Internal Audit ("IA") function as part of becoming a public company. While companies that list on the Nasdaq do not have the same requirement, we believe it is best practice to establish an IA function. The typical IA function is structured as an independent assurance and consulting department that can have varied responsibilities, which may include assessing the company's internal controls and their ability to support the achievement of defined strategic objectives, mitigate key risks, ensure compliance with internal policies, and support financial reporting requirements. The role of IA usually involves assisting management in performing tests and procedures designed to verify the company's compliance with Section 404 of Sarbanes-Oxley, as well as providing comfort to the CEO and CFO when they sign the 302/906 certification attesting to the accuracy of financial information and operating results published in periodic reports.

Given the cost and time needed to hire the company's IA resources, many companies will engage external resources to help support their IA function rather than hiring additional staff. These external resources can work in tandem with the company's existing IA resources through a co-sourcing arrangement, or if the company does not have any IA resources, it may consider a fully outsourced IA function. The cost to engage external resources could be higher than the cost to hire IA resources internally, but this option has several

advantages. Using external resources allows the company to scale up or down rapidly without having to hire or dismiss internal resources. External providers may also have topical specialists who can provide significant value to the IA function and who can transfer additional knowledge to internal resources.

***Treasury and financial risk management:*** A dedicated treasury and financial risk management group is also a requisite for a public company. Often, newly public companies struggle to adequately manage their liquidity, foreign currency exposure, and derivatives used to hedge interest rates and other risks to their business. An experienced treasury and financial risk management function can mitigate the growing pains that come with being a newly public company.

## V. Dealing with the SEC—What do they care about and how can you navigate the process as smoothly as possible?

### A. Overview of the SEC review process

The Division of Corporation Finance (and that is not a typo—it is “Corporation” and not “Corporate”) (“Corp Fin”) within the SEC is, among other responsibilities, tasked with reviewing the registration statements of IPO companies as well as the SEC filings of the thousands of already reporting companies. (Sarbanes-Oxley requires that some level of review of each reporting company be undertaken at least once every three years, and the SEC reviews a significant number of companies more frequently.)

Corp Fin assigns filings by companies based on their industry to one of 9 offices, each headed by an Office Chief (such as the Chief of the Office for Energy & Transportation or the Chief of the Office for Life Sciences and so on). Generally, each industry office is staffed with professionals, primarily lawyers and accountants but also those with specialized expertise such as mining or petroleum engineers who may be involved with the reviews of companies in specific industries. (When you take a moment to reflect on it, you realize that these folks have an awful lot on their plates, particularly when markets are active and there are lots of transactional filings in addition to the ongoing reports that public companies must file.)

It is important to understand that when the SEC staff reviews filings, they are not doing so to say whether or not any IPO or other investment is a good one. Rather, they are primarily focused on ensuring that the SEC’s disclosure requirements for the registration statement are being adhered to and that the financial presentation complies with applicable authoritative accounting literature and SEC staff interpretations and policies dealing with accounting and auditing issues—and even here, the SEC does not pass on whether the registration statement is adequate or accurate (indeed, it is against the law to say that they have).

When your IPO registration statement is first submitted to the SEC, they will assign it, typically within a week or so, to a review team. Typically, this will include a lawyer and an accountant who are the primary examiners, and a more senior lawyer and accountant who are the reviewers. This team will be overseen by the relevant office chief. After the team is assigned, the legal examiner ordinarily will reach out to your outside counsel to let them know that the filing will be subjected to a full review and obtain the appropriate email addresses for where the staff should eventually send their initial comment letter and subsequent correspondence. Your counsel thereafter ordinarily maintains open lines of communication with the SEC staff while the registration statement is being reviewed.



A word on the level of review—the SEC staff does not review each and every SEC filing and, for those filings that are pulled for review, the staff conducts differing levels of review. However, although the SEC does not reveal the criteria that it uses to select filings for review, IPO registration statements almost without exception always get a full review (with the rare exceptions relating to those companies who have publicly traded debt, already have their common stock registered under the Exchange Act for compensation or other reasons or who were recently public and are re-registering).

As noted within Chapter II (Overview of the IPO Process), the SEC staff will take approximately one month to perform their initial review of the registration statement and issue their first comment letter. When this is received (frequently on a Friday afternoon...) it is usually the catalyst for a frenzy of activity as the company and its counsel and auditors, in consultation with the underwriters and their counsel, rush to prepare appropriate responses. The basic format is to resubmit an amended version of the registration statement that has been revised to reflect the SEC staff's comments and, if required, to provide updated financial statements and other recent developments, accompanied by a letter explaining the company's responses to each of the staff's comments. In the authors' experience it usually takes at least a week and a half to two weeks (or more) to do this in a thoughtful way and allow time for internal layers of review both within the company and its auditors. Different practitioners have different approaches to the process, but the authors' general advice is to comply with the staff's comments on specific disclosures where possible, notwithstanding that this may result in some mangling of words that were painstakingly written as part of the drafting process leading up to the initial submission or, when the comment is simply inapposite, to explain clearly and respectfully in the response letter why this is the case. Where staff comments relate to accounting matters, the participation and advice of the company's auditors and accounting advisors are critical—the experienced firms will have a wealth of practical experience on just about every issue that the SEC staff may raise (indeed, the big firms each have partners in their national offices who have backgrounds working in senior capacities at the SEC). Generally speaking, however, it is safe to say that when the SEC staff has issued a comment questioning or seeking to understand the company's accounting in a particular area it is important to respond in a way that is explicitly grounded in the relevant accounting standards and literature. Note that the SEC staff's comment letters and the company's responses will eventually become publicly available on the SEC's website after the IPO occurs.

In an IPO there will typically be several rounds of SEC staff comments and resubmissions of the registration statement in response thereto, with the overall time required for the SEC review phase commonly taking from two-and-a-half to four months. Statistically, studies have shown that in recent years the median time from initial submission to effectiveness for IPO registration statements (which time period also includes the marketing phase as effectiveness of the registration statement occurs after the roadshow just prior

to pricing) is approximately 16-18 weeks. (For purposes of blocking out timetables, the authors generally assume that the SEC staff will take a month to respond to the submission of the initial registration statement, two weeks to respond to the submission of the first amendment, one week to respond to the submission of the second amendment, and several days for subsequent amendments thereafter, although with the exception of the staff's response to the initial submission (which almost invariably appears somewhere close to the one month time frame), response times can vary significantly based on the workload of the review team and other factors, including the difficulty of any specific issues that are raised.) To the extent that the overall review period takes longer than this, it is usually due either to the fact that the company has decided for whatever reason not to move as quickly as it could have (or perhaps chosen to take a "resistant" posture to staff comments) or because problematic questions relating to its historical accounting have been raised. While "legal" comments on the disclosure can usually ultimately be resolved by revising the relevant disclosure, comments relating to historical accounting may result in the need to restate the financial statements included in the registration statement, a process which can take time and result in a great deal of attention from the company's auditors. Avoiding this unfortunate situation should be a key objective of the company as it is preparing the financial statements to be included in the registration statement and, in the authors' view, is yet another reason why it is advisable to engage auditors and accounting advisors with significant relevant experience. Indeed, in order to make the SEC review process as expeditious as possible a company should draw on the well of experience of its counsel, accounting advisors and auditors when preparing the entire registration statement to anticipate the areas that will be of particular interest and concern to the SEC staff.

In some cases, the appropriate application of generally accepted accounting principles may not be clear or there may be questions concerning the age, form or content of financial statements required to be included in a filing. In these circumstances, it may make sense to consult with the accounting staff of the SEC (generally, the SEC's Office of the Chief Accountant addresses the former types of questions while the accounting staff within Corp Fin resolves the latter) prior to the initial submission of the registration statement, which although it may take additional time on the front end can save time and aggravation overall. Analogously, albeit less frequently, there may be uncertainty about a legal aspect of the proposed transaction and pre-filing consultation with the legal staff of the SEC may be warranted. The SEC has published specific guidelines as to how such consultations should be handled, and your counsel and auditors should have practical experience in doing so. Certainly, one way or the other it should be on your pre-filing work plan to at least expressly consider with your auditors and counsel whether there are any items that warrant such a pre-filing consultation with the SEC staff. In recent years, the SEC staff has been increasingly open to communications and encourages outreaches where necessary.

To give you a little bit of a sense of the back and forth of the SEC comment process, below is a table that lays out some of the metrics regarding the back and forth between a real (but anonymous) IPO issuer and the SEC during the review of the registration statement for that company’s IPO. The SEC review process for this transaction, while speedier than average, was not atypical for a well-managed and well-advised company in terms of the number, and number of rounds, of comments received and the overall time taken.

### Example of SEC comment letter process

Area (# of comments)	1st round	2nd round	3rd round	Total
Summary	3	-	-	3
Risk factors	3	1	-	4
Business and industry	6	2	-	8
MD&A	7	4	1	12
Non-GAAP Financial Measures	-	1	-	1
Financial statements – Overall	3	1	-	4
Financial statements – Revenue Recognition	2	-	-	2
Financial statements – Segments	1	-	-	1
Financial statements – Subsequent Events	1	-	2	3
Other financial	4	2	-	6
<b>Total</b>	<b>30</b>	<b>11</b>	<b>3</b>	<b>44</b>

## B. Typical areas of SEC comment

Outside of the accounting area, the SEC staff tends to focus on the overall quality of the disclosure, with particular attention paid to the risk disclosures and the “Summary” portion of the registration statement and on ensuring adherence to the specific requirements of the SEC relating to the description of the company’s business itself. As specific examples, in recent years, the SEC staff has begun issuing comments focusing on climate-related risks and opportunities as well as cybersecurity, which may be required in the company’s description of its business, risk factors or MD&A. Ideally, your counsel will be thoroughly familiar not only with the specific formal SEC requirements for the content of the registration statement but also facile with writing the disclosures in a plain English, factual and “fair and balanced” manner that is less

likely to draw fire during the review process. Unlike an understanding of the common and recurring areas of SEC staff comment in the accounting area, which can be vitally important to understand as you first start to put together your financial statements and think through the financial metrics that you will be presenting to investors, there is less advantage to be gained from a deep dive into the SEC staff's precedent activity on legal comments until you reach the stage of putting pen to paper on your registration statement.

The SEC staff comments that can be the most problematic for an IPO are those that call into question the company's historical accounting or how its financial statements or pro forma financial information have been presented, those regarding recent or anticipated acquisitions and those relating to complex tax and organizational structures. We touch on several of the most common areas of accounting comment below—such as Management's Discussion and Analysis, use of non-GAAP financial measures ("NGFMs"), segment reporting, business combinations, revenue recognition, stock-based compensation, income taxes and presentation of earnings per share.

**Non-GAAP financial measures.** As companies plan for an IPO, among the many choices they must make is how to utilize non-GAAP financial measures in their IPO filings and in discussions with potential investors. Use of the right NGFMs allows companies to highlight key facts and circumstances and position themselves to the investment community and against their peers. However, while NGFMs can be a key tool during an IPO, companies should carefully consider the costs and benefits associated with their use. The SEC will closely review the basis of calculation and level of disclosure. The investment community will expect consistent usage of the NGFMs and consistency with peers both during and following the IPO. Thus, appropriately identifying these items early in the IPO planning process is critical. In a worst case scenario, improper usage or disclosure of NGFMs can lead to unanticipated costs and delay the company's IPO. It can also have a negative impact on the company's share price after its IPO.

Companies often present certain quantitative measures of past performance, financial position or cash flows that make various adjustments (inclusions or exclusions) to measures reported in the GAAP financial statements. Such NGFMs are permitted to be included in registration statements, including IPO filings, as long as they meet the requirements of Regulation G and Item 10(e) of Regulation S-K. Examples of common NGFMs can include adjusted earnings before interest, taxes, depreciation and amortization ("Adjusted EBITDA"), or free cash flow.

Typical areas of SEC comment relating to NGFMs include:

- equal or greater prominence given to NGFMs relative to the equivalent GAAP measure;
- reasons why management believes NGFMs provide useful information to investors;

- items in the reconciliation of NGFMs to the most comparable GAAP measure, including whether such adjustments represent ordinary course operational expenditures where inclusion could cause the NGFM to be misleading;
- use of individually-tailored accounting principles (“ITAPs”), such as those relating to revenue;
- labeling of items as non-recurring, infrequent or unusual when a similar item has occurred in the prior two years and/or is reasonably likely to occur again; and
- labeling NGFMs as “pro forma” when they do not comply with the provisions of Article 11 of Regulation S-X.

**Management discussion and analysis.** The SEC continues to emphasize the importance of MD&A through the comment process, as well as its rulemaking. Indeed, on November 19, 2020, the SEC adopted changes to the specific MD&A requirements intended to modernize and enhance the quality of MD&A disclosure for investors while simplifying compliance efforts for companies, and also provided guidance for the discussion of key performance indicators and metrics in MD&A disclosure.

A stumbling block that many companies face is their inability to describe the effect of underlying factors on the company’s performance. A registration statement and all future financial statement filings with the SEC will require the inclusion of MD&A related to a company’s financial statements. Specifically, MD&A is intended to give the reader information about the quality of the company’s earnings and cash flow so that investors can ascertain the likelihood that past performance is indicative of future performance. The company will need to describe in-depth such items as changes in sales volumes and cost structures, liquidity and capital resources, sources and uses of cash flows, vendor relationships, employee compensation, unusual nonrecurring charges, significant environmental exposures, off-balance sheet arrangements, contractual obligations and other risks and uncertainties.

As a company completes its annual and quarterly financial statements, it should take time to write its MD&A. It can be very difficult to remember, three years after the fact, why insurance costs, for example, went up or when a marketing campaign commenced. The practice of writing a high quality, comprehensive MD&A will expedite a company’s registration process and be a major step toward operating like a public company. The SEC comment letter process has reinforced the well-established MD&A objectives that disclosures should be transparent in providing relevant information, tailored to the company’s facts and circumstances, consistent with the financial statements and other public communications and comprehensive in addressing the many business risks that exist in today’s economic environment.

Typical areas of SEC comment relating to MD&A include:

- addition of an executive overview section;
- explanation of the underlying specific drivers behind changes in financial position, results of operations and cash flows;
- reasons for and specifically quantifying significant underlying variances, even when they offset each other;
- discussion and quantification of the impact of pricing and volume changes on results of operations;
- material known trends that may positively or negatively impact future results of operations and liquidity;
- quantified impact of foreign currency fluctuations on revenues, expenses and margins;
- quantified impact of acquired or disposed businesses on results of operations;
- discussion of known trends, events or uncertainties that are reasonably likely to impact future liquidity;
- further disclosure of sources and uses of cash and drivers of cash flows as opposed to repeating what can already be found on the face of the cash flow statement itself;
- description of the covenants in the company's debt agreements and an indication regarding compliance;
- amounts of cash held overseas, especially where a company has asserted that it will permanently reinvest foreign earnings;
- discussion of critical accounting estimates, qualitative and quantitative disclosures about market risk (i.e., interest rate risk and foreign currency exchange risk); and
- impacts on specific current issues, which as of the date of this publication could include the COVID-19 pandemic, inflation, supply chain disruptions, the Russia/Ukraine conflict, rising interest rates, etc.

**Climate change matters.** While the SEC proposed sweeping new climate-related disclosures in March 2022, even in 2021 the SEC staff began a renewed focus on the quality and adequacy of climate-related disclosures under existing rules, specifically as detailed in the SEC's 2010 interpretive release. These comments have been largely focused on information related to climate change-related risks and opportunities that may be required in a company's description of business, legal proceedings, risk factors, and MD&A. In these letters, the staff frequently commented on:

- inconsistencies between a registrant's corporate social responsibility report and its SEC filings;

- the lack of disclosure in a registrant’s SEC filing of the risks, trends, and impact of climate change for the registrant and its business; and
- the lack of disclosure in a registrant’s SEC filings related to pending, or existing climate-related legislation and regulations that could have a material impact on a registrant’s business.

**Segment reporting.** Private companies are not required to report financial information about their segments, so this is usually a major change for companies undertaking an IPO. Segment reporting has been an area of recurrent comments from the SEC, which frequently challenge the identification and aggregation of operating segments. Reporting only one segment can be considered a “red flag”, depending on the size and maturity of a company, that will frequently attract a comment.

When operating segments are aggregated, questions often center on the application of the “similar economic characteristics” criterion, with special attention paid to the similarity of long-term average gross margins. Companies frequently misidentify their operating segments (which is the starting point for the determination of reporting segments) and should be prepared for the SEC to request a copy of the reporting package that the chief operating decision maker (“CODM”) receives (and forms the basis for determination of operating segments). This is often the CEO or a combination of the CEO and other decision makers (e.g. the Board of Directors, COO, CFO).

Segment reporting is based on the information included in the internal reporting package and it is presumed that all information made available to the CODM is actually used to assess the performance of the business and make decisions about the allocation of resources. The objective is for investors to have the benefit of seeing the business in the same level of detail as management. While the definitions of operating segments and reportable segments are provided in the accounting literature and are dependent upon what information the CODM uses to assess performance and allocate resources, companies often fail to consider that these accounting conclusions not only impact the financial statements but also need to align with the information in MD&A, the equity story, the company website, and any other public marketing materials. The way the business is portrayed needs to be consistent across all publicly available information.

The SEC will also remind registrants that they are required to disclose certain enterprise-wide information, such as disaggregated revenue by products or services (unless impractical to do so, which should be stated) and geographical disclosures (revenues and assets) by country, if 10 percent or more of the consolidated totals.

Typical areas of SEC comment relating to segment reporting include:

- determination of the CODM, which may not always be a single individual;
- exclusion of components of a business as a segment when the CODM receives reports of that component's operating results on a regular basis;
- aggregation of operating segments into one reportable segment, which the SEC has noted represents a "high hurdle" that is only suitable in certain limited situations; and
- inconsistencies between segment reporting and how the business is described in the business section, MD&A, and other publicly available information.

**Business combinations.** U.S. GAAP requires that the purchase price allocation in a business combination begin with an analysis to identify all tangible and intangible assets acquired. Intangible assets, such as patents, copyrights, brand names, customer lists and above/below market contracts should be identified and the fair value of each asset must be estimated. The total purchase cost is allocated based on the relative fair values of the individual assets.

Underlying assumptions and data used to develop the valuations should be adequately prepared by companies and challenged by their auditors. Note, valuations are most commonly prepared with support from an external valuation provider.

In addition to providing the acquisition disclosures required under Accounting Standards Codification ("ASC") 805, "Business Combinations," companies need to evaluate the significance of acquisitions completed during the most recent fiscal year included in the S-1, as well as any probable acquisitions not yet closed. Registrants may be required to provide audited historical pre-acquisition financial statements of the acquiree(s) and pro forma financial information in accordance with Rule 3-05 of Regulation S-X.

Typical areas of SEC comment relating to business combinations include:

- appropriateness of the fair values, key assumptions, and related disclosures used to record assets and liabilities acquired;
- additional information about the qualitative factors that resulted in significant goodwill;
- accounting for changes in a valuation allowance for acquired deferred tax assets and the resolution of uncertain tax positions; and
- disclosures associated with contingent consideration and related accounting.



**Revenue recognition.** Revenue recognition still receives a great deal of attention from the SEC. ASC 606, “Revenue from Contracts with Customers,” provides a single, comprehensive model to be applied in all industries.

Typical areas of SEC comment relating to revenue recognition include:

- performance obligations—the nature of performance obligations, why goods or services are distinct, and disclosure of remaining performance obligations. Also, comments related to information provided in other parts of the filing that appear inconsistent with the number of performance obligations in a contract;
- variable consideration—the determination of the transaction price and how a company estimates variable consideration;
- recognizing revenue—the timing of when control transfers, the method of recognizing revenue over time, and accounting for licensing arrangements;
- costs to obtain a contract—the determination of the appropriate costs to capitalize, the amortization period, and related disclosures (including election of practical expedients);
- gross versus net presentation—judgments related to gross versus net presentation of revenue, including an assessment of whether the company controls the good or service being provided to the end customer; and
- disaggregated revenue—disaggregation disclosures that appear inconsistent with information provided in other parts of the filing or in other forums, such as investor presentations.

**Stock-based compensation.** “Cheap stock” refers to the issuance of equity instruments (e.g., options, warrants, common stock or restricted stock) typically during the 12 to 18 months preceding an IPO, for a price (or with a strike price) that is below the expected IPO price. This issue usually arises in connection with the granting of employee stock options and often results in the recognition of additional stock-based compensation expense.

The SEC expects that companies will provide critical accounting estimate disclosures within the MD&A section of the registration statement surrounding methods that management used to determine the fair value of the company’s shares and the nature of the material assumptions involved. Alternatively, companies may request confidential treatment of this information by submitting a letter to the SEC with such disclosures. With respect to valuations performed, management should include a detailed discussion of the valuation approaches for estimating the value of an enterprise, such as the cost, market and income approaches, various methodologies for allocating the value of an enterprise to its common stock, the weighting of the different models used and any significant changes in the weighting over time.

Companies may receive comments requesting explanations for valuations that appear unusual (e.g., unusually steep increases in the fair value of the underlying shares leading up to the IPO). Companies preparing for an IPO need to carefully review the pricing history of their equity issuances. For example, where option exercise prices are significantly less than the price of other equity instruments sold near the dates of option grants, there will be close scrutiny by the SEC, and the closer the grant dates are to the IPO, the more intense the review.

Typical areas of SEC comment relating to stock-based compensation include:

- significant factors, assumptions and methodologies used to determine the fair value of the underlying common stock;
- whether a contemporaneous valuation by an unrelated valuation specialist was performed;
- the valuation range determined by various methodologies and the combination or weighting of those methods;
- significant factors contributing to the difference between the fair value as of the date of each grant and the estimated IPO price range;
- explanations of why or whether marketability discounts, illiquidity discounts and common stock discounts (due to preferential rights of preferred stock) were used; and
- determination of comparable companies used.

**Income taxes.** The accounting for income taxes, including related disclosure requirements, is often complex and involves significant judgment.

Typical areas of SEC comment relating to income taxes include:

- disaggregation in the income tax provision disclosure;
- sufficiency and consistency of indefinite reinvestment disclosures;
- interplay between indefinite reinvestment assertion and liquidity;
- incremental disclosure of how the results of operation are impacted by having proportionately higher or lower earnings in jurisdictions with different tax rates; and
- sufficiency of valuation reserves and uncertain tax provisions.

**Earnings per share (“EPS”).** Private companies are not required to present EPS and for companies with complex capital structures—including multiple types of equity, different types of potential common shares and various classes of common stock—this calculation can be complex. To further complicate matters,

companies may have participating securities that are required to be included in the calculation of basic EPS using the two-class method (under which EPS is calculated separately for each class of common stock and any participating securities).

Common shares (securities or other contracts that may entitle their holders to obtain common stock, such as options, warrants, forwards or other contracts) may be participating securities if, in their current form, they are entitled to receive dividends when declared on common stock. For example, an unvested, share-based payment award that includes nonforfeitable rights to dividends or dividend equivalents meets the definition of a participating security.

When dividends declared in the latest year exceed earnings for the previous twelve months, the SEC presumes they will be funded with proceeds from the IPO and, therefore, registrants are required to present pro forma earnings per share, giving effect to the increase in the number of shares whose proceeds are assumed to be used to pay the dividend. This requirement applies to dividends declared after the latest balance sheet included in the registration statement, as well as planned but not yet declared dividends.

Typical areas of SEC comment relating to EPS include:

- treatment of nominal issuance/penny warrants; and
- inclusion of pro forma EPS due to automatic conversion of preferred stock upon IPO.

***Pro forma financial information.*** The objective of pro forma financial information is to provide investors with an understanding of the impact of particular transactions by indicating how they might have affected the historical balance sheet and income statement had they occurred at an earlier date. Companies with significant business combinations or dispositions, previous history as part of another entity, material repayment of debt, changes in capitalization at the effectiveness or close of an IPO and other events and transactions that have had or will have a discrete material impact on the financial statements are likely required to include pro forma financial statements in the registration statement.

Historically, typical areas of SEC comment relating to pro forma financial information include:

- sensitivity analysis around how a registrant's EPS would be impacted in the event the number of shares issued or related offering price changes; and
- use of pro forma adjustments in NGFMs.

While the SEC has amended the pro forma rules, we still expect pro forma financial information to be an area of SEC focus during the comment letter process.

**Debt, Warrants, and Equity.** While most recent comments related to debt, warrants, and equity have been applicable to SEC filings for de-SPAC business combinations, which are outside of the scope of this publication and briefly discussed in “A few words on special purpose acquisition companies (“SPACs”)” debt, warrants, and equity are still a common area of comment for IPOs.

The SEC staff has focused on the transparency and quality of the disclosures around these judgments and estimates, frequently requesting:

- the registrant’s consideration of conversion and redemption options in determining debt or equity classification;
- support for the classification of financing transactions as extinguishments or modifications of debt; and
- expanded disclosures of the material terms of debt agreements.

## C. Publicity—Do I really need to take a vow of silence?

There tends to be a lot of agita about the constraints on publicity applicable to companies undertaking an IPO. Below is a discussion of the rules themselves, which is of necessity a little bit technical, followed by some practical observations.

Under the relevant legal framework in the United States, a company that is pursuing an IPO is generally not allowed to offer to sell its stock before filing a registration statement (and this, mind you, is the public filing as opposed to a confidential submission). During the period between the public filing of the registration statement and the time it becomes effective at the conclusion of the roadshow, oral offers are permitted and written offers through the use of the preliminary (or “red herring”) prospectus included in the registration statement may be made once an anticipated price range has been included. (While SEC rules permit written offers other than the traditional prospectus, referred to as “free-writing prospectuses”, in certain circumstances, IPO issuers are subject to significant constraints on the use of these non-traditional offering documents and counsel should be consulted if consideration is being given to the use of any such documents.) Only once the registration statement becomes effective at the conclusion of the roadshow and prior to pricing, however, may buy orders be accepted and the stock actually sold.

As discussed in Chapter II (Overview of the IPO Process), there is a limited exception to these rules permitting companies and their representatives to test-the-waters by communicating with certain institutional investors, either prior to or following publicly filing of the registration statement, in order to determine whether such investors might have an interest in the offering. Any TTW meetings or other forms

of pre-deal investor education should be carefully vetted in advance by counsel, as this exception does not obviate the need to comply with the more generally applicable constraint on offers. Refer to Chapter VII (Marketing, Pricing and Distribution) for further details on the marketing process.

“What is all the fuss about?”, you might well ask. “I had not intended to run around selling the stock before the roadshow in any event and was not planning on sending out written offers either?” The rub is that the SEC and the courts construe an “offer to sell” broadly to include the publication of information and publicity efforts made in advance of a proposed offering that have the effect of “conditioning the public mind” or “arousing public interest” in the company or in its securities. Indeed, a communication may be construed as an “offer to sell” even if it does not make reference to either the securities being offered or the offering itself. Moreover, the term “writing” is similarly broadly construed, and can include television and press coverage where there has been company involvement.

That being said, your initial reaction is not really wrong. First, the SEC rules specifically state that communications by a company made more than 30 days prior to filing the registration statement that do not reference the proposed offering are generally permissible, provided that the issuer takes reasonable steps to prevent further distribution or publication of the communication within the 30-day period. Second, the SEC’s rules also expressly permit a company, subject to a number of limitations, to continue to release factual (but not forward-looking) information about its business in a manner consistent with past practice to persons (such as customers) other than in their capacities as investors or potential investors in the issuer’s securities. These express rules, taken together with the general principle that only communications that are “offers” (even as broadly defined) are problematic in the first place, should give companies significant comfort that they can go about their day to day business throughout the IPO process. Indeed, you will substantially mitigate the risk of a problem in this area if you simply avoid:

- public references to the IPO prior to the public filing of the registration statement or outside of legally compliant communications after filing, including via press interviews (whether on or off the record), speeches or conferences;
- communications with analysts not in the underwriting syndicate;
- communications with potential investors prior to the public filing (except for legally compliant TTW) or outside the legally compliant process after the filing;
- public disclosure of forward-looking information regarding the company’s financial or operational results; and
- unduly “hyping” statements about the company or its prospects.

## VI. Your relationship with the underwriters

### A. The underwriting team members and how they can help with your IPO

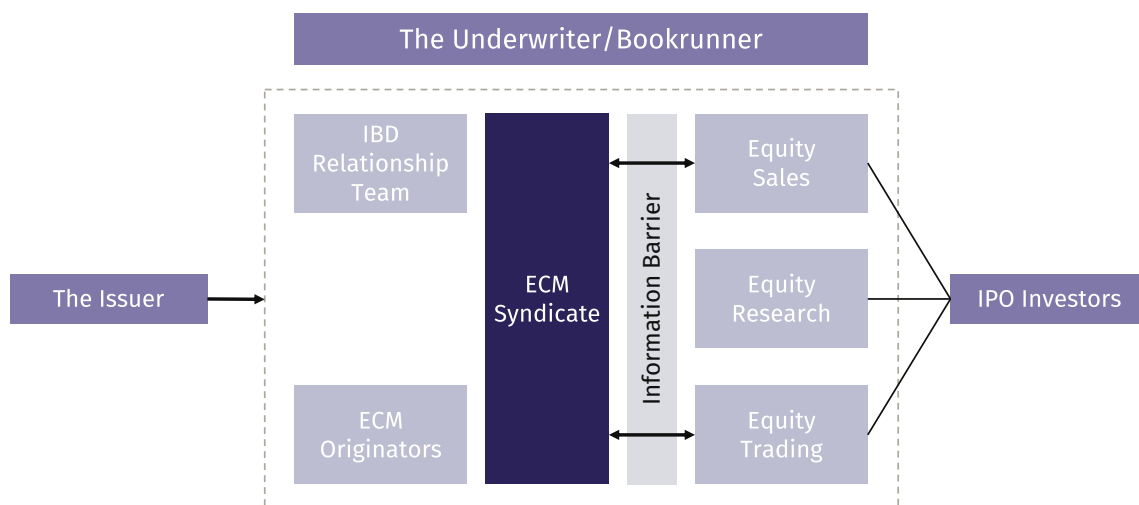
As noted in Chapter II (Overview of the IPO Process), the lead underwriters (sometimes also referred to as the “lead managers” or “bookrunners”) are critical to the success of an IPO, with a role that extends well beyond simply distributing the offered stock. Among their many contributions, the lead underwriters will analyze the company’s industry to assess potential investor demand and advise the company and its shareholders on market positioning, investor receptivity and valuation and assist the company in developing the investment story necessary to market the issue. The lead underwriters will also advise on transaction structure and provide an overall level of coordination to the market-facing aspects of the process.

It may be worth reviewing for a moment what the various members of the team at an investment bank actually do on an IPO. The lead managers’ investment bankers are the company’s principal points of contact with all of the underwriters throughout the IPO process—they conduct due diligence, help the company define its investment proposition and market positioning, participate in the preparation of the registration statement, develop valuation models, manage the roadshow, and collaborate with equity capital markets and syndicate personnel to price and size the offering. These banks are sometimes referred to as the “bookrunners” because (at least before the advent of computers) they would assemble all of the orders from the various institutions and other investors in the IPO in a “book”, which would tell them how many shares each investor was willing to purchase and at what price. The bank whose name appears in the top left position in the list of underwriters appearing on the cover page of the prospectus is the “lead left bookrunner”, or if there are no other bookrunners in the deal, just “the bookrunner.” The research analysts, who due to regulatory constraints imposed on the banks typically no longer appear alongside the investment bankers, also conduct due diligence, develop financial models and forecasts of the company’s future operating results, educate the investment bank’s sales force about the company and its investment merits, and express their views about the offering to the investment bank’s commitment committee (who ultimately are the ones who decide whether their bank will participate in or “commit” to the offering). The research analysts also communicate with institutional investors during the marketing phase and, following the IPO, issue reports and research relating to the company. Equity capital markets and syndicate personnel are the “product specialists” on IPOs and recommend the offering price, size, and timing based on market conditions, company metrics, and investor demand. They also arrange the underwriting syndicate (which is to say, coordinate bringing in the various investment banks who will be participating in the offering and manage the logistical side of their interactions), manage the book-building process,

interact with the sales forces in assessing investor feedback during the roadshow, participate in discussions of the offering terms, allocate the shares to investors, and assist with aftermarket price support. And, last but not least, members of the sales force do exactly what you would expect—interacting with investors during the marketing phase and soliciting indications of interest to buy the stock.

The following chart illustrates how the underwriter team connects the company with the IPO investors:

## How the Investment Banks/Bookrunners Fit in—Syndicate & Distribution



Source: PwC

### B. How to select underwriters

Since the underwriters play a crucial role in successfully executing your IPO, it is worth discussing in somewhat greater depth how to go about selecting the underwriting team for your company. You should consider several factors when selecting a lead managing underwriter:

- experience—the more issues an underwriter has successfully managed, both in total and within the company’s sector, the more likely it will be to understand and execute successfully the elements required for the IPO to succeed. Also pay attention to the bank’s track record in executing IPOs; consider how many deals the bank has initiated and compare that to the number of deals successfully completed—it should give you some insights as to the strengths and potential weaknesses of any particular lead bank;

- industry expertise—an underwriter with industry knowledge can provide an edge when launching and marketing an offering;  
research coverage—as we have mentioned and will discuss further in Chapter VII (Marketing, Pricing and Distribution), the research analysts play a key role in your IPO. As a result, selecting an underwriter with strong research analysts will increase the likelihood of executing a successful IPO;
- credit—investment banking firms seeking mandates to underwrite the company’s IPO may be willing to also assist the company in refinancing its bank debt or bonds in connection with the IPO or secure new or additional liquidity commitments;
- distribution capabilities—some underwriters have better connections within the investment community than others. Some underwriters have broad retail distribution capabilities (the ability to reach a lot of individual investors) and some have particularly strong relationships with the large institutional investors who tend to be the ones who set the valuations and determine the success of the individual deal. Some banks, of course, have both;
- team focus—since the IPO process is time intensive, it is important to select a lead underwriter with adequate resources for meeting important deadlines; and
- range of services—an underwriter with a full platform of products and services, such as equity, debt and advisory capabilities, foreign exchange management and prime brokerage, can assist an issuer with other products and services as the company grows following the IPO.

If you select more than one lead underwriter, you will need to appoint which bank will take which role. The primary roles are stabilization, billing and delivery and roadshow logistics. The banks will likely have a strong preference for being designated as the stabilization agent for the IPO because that role allows the bank to obtain trading color and be involved following your IPO. It is not uncommon for the company to hold off on designating the stabilization agent until later in the IPO process. We will discuss how stabilization affects an IPO in the next chapter.

The responsibility of a co-manager is to focus on supporting the deal throughout the IPO process and to help market the transaction to their own web of investors. Co-managing banks conduct due diligence, provide additional research coverage and aid in market making after the public offering. They are also responsible for helping to build an order book. Typically, co-managers are invited to join the underwriting syndicate at a certain point following the initial submission of the registration statement and sometimes quite close to the launch of the IPO.



## C. The underwriting agreement

The legal contract between the company going public (and any selling stockholders) and the underwriters is called an underwriting agreement, which is signed at the time the company agrees to the price at which to sell the shares to the IPO investors (i.e., at the very end of the IPO roadshow). Until that time the parties work together based on trust and mutual expectations, and generally at their own risk and expense.

As memorialized in the underwriting agreement, the typical arrangement in the U.S. between the company and the banks takes on the form of a “firm commitment,” in which the underwriters pledge to buy all of the stock offered in the IPO and resell it to the public. This arrangement offers the company the most security because the owners know they will receive the full sales price of the issue at the time the underwriting agreement is executed, absent something going dramatically wrong. In theory a firm commitment underwriting gives the bank significant exposure since they have just agreed to purchase all of the IPO stock regardless of whether they can place it with retail or institutional investors. In practice, this exposure is quite minimal since the banks do not sign the underwriting agreement (and hence “firmly commit” to purchase the stock) until after they have lined up buyers for every share—and typically significantly more than every share. If something goes dramatically wrong enough for all of these investors to back out of their agreements to buy the stock from the investment bank, then presumably something has gone sufficiently wrong with the issuer or the markets that the banks could also cancel the underwriting agreement. Hence the minimal nature of the exposure from a practical perspective.

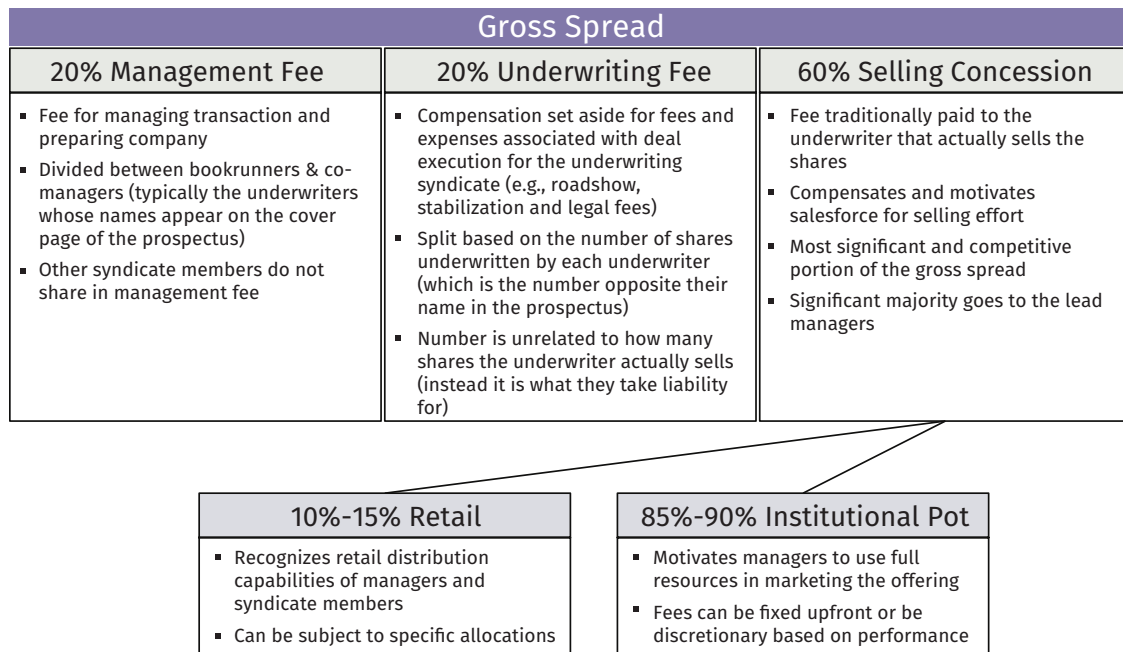
For example, an underwriting agreement typically will excuse the underwriters from their obligation to purchase the stock if the underwriter determines between the signing and closing that the Company’s representations in the underwriting agreement were materially false at the time made, if some event happens between signing and closing that makes the reps that were true at signing no longer true at closing, or if some circumstance arises in the broader market that makes it inadvisable, typically in the underwriters’ sole opinion, to consummate the transaction. However, for the underwriters, it would be a significant blow to not only their relationship with their client (the IPO issuer), its board members and its backers, but also to the banks’ reputation in the industry to not consummate an IPO once it prices. Accordingly, almost all IPOs that get to the stage where the underwriting agreement has been executed ultimately close. A cancelled IPO is so rare in fact that all of the instances where this has occurred are somewhat famous in the world of securities offerings. The most famous examples are that of the first IPOs of Eagle Computer in 1983 and of BATS Global Markets in 2012. In the case of Eagle Computer, the president of the company (accompanied by the owner of the local yacht company) crashed his new Ferrari at high speed and was killed on the day the offering priced, resulting in the underwriters cancelling the transaction hours after it was inked. In the case of BATS Global Markets, BATS, which operates a securities exchange,

was attempting to make its own IPO the first IPO to list on its exchange, when on the first day of trading a spectacular glitch in the company’s trading systems caused a halt to trading in a number of stocks, including the stock of BATS itself. Given the circumstances, the company and its underwriters decided to cancel the offering. Tragic and tragicomic outcomes, but ones that give you a sense of how rare and how extreme a situation the underwriters typically need to face before they pull the plug on an IPO that has already priced.

## D. Syndicate economics

The underwriters are compensated by purchasing the company’s shares at a discount to the IPO price, which is called the “underwriting discount” or “gross spread.” The underwriting discount is almost always calculated as a percentage of the gross proceeds and typically ranges from four percent to seven percent for an IPO but may be a lower percentage in the case of large offerings. The gross spread is, in turn, divided into three separate components—the management fee, the underwriting fee and the selling concession.

## Syndicate Economics

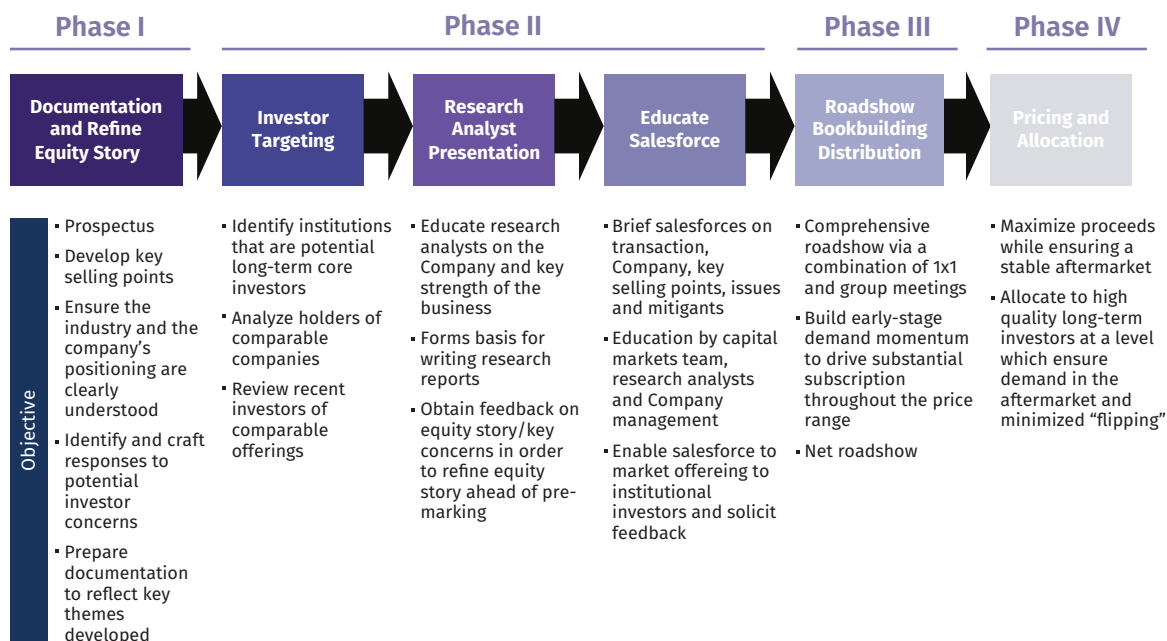


## VII. Marketing, pricing and distribution

### A. Overview of the marketing process

In some respects, the marketing process begins in the earliest meetings between the company and the prospective underwriters when the company's operating strategy, market positioning and valuation and target investor mix are discussed. The lead underwriters assist the company in developing a comprehensive marketing plan for the offering, taking into consideration the company's investment themes and targeting specific investors. Later in the IPO process, the company will meet with the research analysts, the underwriting sales force and ultimately with prospective investors in what is called a roadshow. The marketing process can be thought of as having various phases, as depicted in the following diagram. Phase I typically commences in advance of the overall IPO marketing process (pre kickoff) while the balance of the other phases would occur in the typical 4-6 months filing process that most IPOs require from kickoff to pricing.

### IPO Marketing Process



Source: PwC

## B. The role of research analysts in marketing your IPO

After the underwriters have been hired, the company will host a diligence session with the respective research analyst(s) from each underwriter. Typically, the investment bankers will not be in attendance at this session due to legal restrictions intended to bolster the independence of the analysts. If the bankers are in attendance, the meeting will need to be “chaperoned” (usually by underwriter’s counsel) to ensure that the analysts are able to freely interface with the company without any form of censorship or guidance by the investment bankers. At this meeting, the management team will typically provide an overview of its business, strategy and financial model. This interactive session is instrumental for the research analysts since it will be the foundation on which they prepare their financial models. As a result, you should be prepared for the analysts to pepper the management team with questions about all facets of the company. From this collaborative process each analyst will then produce their own proprietary valuation model, which should be expected to differ in some ways from the management model.

To create their own financial model of the company, the analysts will make assumptions about the company’s growth rate and the company’s industry at large. The analysts will then use multiples, typically a ratio of a valuation metric like market capitalization or enterprise value to a financial performance metric such as earnings per share, sales, or EBITDA, to reach a final valuation of the company. It is essential to the veracity and the development of their models that the analysts are not basing their projections of future growth or profitability on outdated or incomplete information, as the data that you provide will be the basis for many of the assumptions that they make and share with buy-side clients during this investor education process.

The analysts will also develop models based on the comparable companies (“comps”) in your peer universe: the set of similar companies that operate in the same industry as the company. Every IPO bound company is going to be compared by analysts and investors with other public companies, if any, that are in its peer group. Although the company may be uniquely placed in the market such that your peers may be considered (and rightly so) inferior, this sort of competitive intelligence is sensible and can alert the company to the practices of, and investor expectations for, public companies in your industry.

# Illustrative IPO Valuation Matrix

## \$400m primary offering

Assumptions		Valuation		
		Low	Mid	High
Total offering				
	\$400			
4	Primary proceeds	10.0x	11.0x	12.0x
	400	\$253	\$253	\$253
	Secondary proceeds			
	0			
5	IPO discount			
	15%			
6	Debt paydown			
	100%			
	Pre-IPO debt			
	\$946			
	Pre-IPO cash			
	34			
	Pre-IPO net debt			
	912			
	Net debt / 2015E EBITDA			
	3.6x			
	Post-IPO debt			
	\$574			
	Post-IPO cash			
	34			
	Post-IPO net debt			
	540			
7	Net debt / 2015E EBITDA			
	2.1x			
	LTM EBITDA			
	\$137			
	CY 2015E EBITDA			
	\$253			
	CY 2016E EBITDA			
	\$325			
	CY 2015E Net Income			
	\$74			
	CY 2016E Net Income			
	\$125			
<b>Key drivers of valuation</b>				
1	Multiple range			
2	Earnings metric (forward)			
3	Free float post IPO			
4	Primary / secondary split			
5	IPO discount			
6	Use of proceeds			
7	Leverage			
(\$ in millions)				
1	Assumed TEV/EBITDA	10.0x	11.0x	12.0x
2	2015E EBITDA	\$253	\$253	\$253
	Fully-distributed Enterprise value	\$2,525	\$2,778	\$3,030
	Less: pro forma net debt	(540)	(540)	(540)
	Implied equity value	\$1,985	\$2,238	\$2,490
<b>At IPO</b>				
	Implied equity value at IPO	\$1,726	\$1,946	\$2,166
	Plus: pro forma net debt	540	540	540
	Implied enterprise value	\$2,266	\$2,486	\$2,706
3	% of company floated (post-IPO)	23.2%	20.6%	18.5%
	% of company retained (post-IPO)	76.8%	79.4%	81.5%
<b>Fully distributed multiples</b>				
	Implied 2015E TEV/EBITDA	10.0x	11.0x	12.0x
	Implied 2016E TEV/EBITDA	7.8x	8.5x	9.3x
	Implied 2015E P/E	26.7x	30.1x	33.5x
	Implied 2016E P/E	15.9x	18.0x	20.0x
<b>At IPO multiples</b>				
	Implied 2015E TEV/EBITDA	9.0x	9.8x	10.7x
	Implied 2016E TEV/EBITDA	7.0x	7.6x	8.3x
	Implied 2015E P/E	23.2x	26.2x	29.1x
	Implied 2016E P/E	13.9x	15.6x	17.4x
<b>Credit metrics</b>				
7	PF net debt / LTM EBITDA	3.9x	3.9x	3.9x

It's worth remembering that although the research analysts are essentially "public-side" employees at the underwriter, they are temporary "private-side" during the IPO process. Indeed, they are effectively the company's voice to the street during the IPO process and as a result are an essential link between the company and the investors in your stock. Due to liability concerns, the company typically does not communicate to the street its projections for its business. And that's one of the areas where the research analysts come in. Through the diligence and other communication with company management, the research analysts form their own views on how the company will perform in the coming years and generate their own models. Although the research analysts do not publish reports until 25 days after the IPO, they do talk to investors, who will frequently call the analyst they have a relationship with at that underwriter to discuss the analyst's model and views of the company. In other words, the potential investors will hear directly from management during the roadshow (discussed below) and will also get another perspective on the company by speaking with the research analysts.

In addition to direct conversations with potential investors, the other input the research analysts have in the marketing of your IPO is the teach-in deck. In addition to the salesforce memorandum, which is a document generated by the coverage bankers at the underwriter that summarizes the roadshow deck and registration statement, the sales force receives the research teach-in deck from the analysts. The research analyst teach-in deck includes the research analyst's view of the model and valuation. While it is an internal document, it plays an important role in educating the sales force. Once the sales force receives the salesforce memo, typically the underwriter will circulate an internal email announcing the IPO. With the salesforce memo, the teach-in deck and the internal email, the sales force is now primed to hear about the company directly from management at the kick-off of the roadshow.

### C. Testing-the-waters (TTW)

Traditionally, building investor demand for an IPO was driven primarily by a “roadshow” or marketing process with investors such as mutual funds and hedge funds over a 1-2 week period just before pricing where management discussed their company's strategy and goals in one to one meetings. However, the process of building investor demand has changed over the last 10 years as a result of two important events. First, in 2012 the JOBS Act was passed which enabled companies contemplating an IPO to conduct “testing-the-waters” meetings with qualified institutional buyers and other institutional accredited investors before publicly filing a registration statement. Such TTW meetings help inform the company's and underwriters' views of the offering and provide feedback which management can use later on in the actual roadshow, which can be especially valuable if the company's story is complicated or if management has limited experience making investor presentations. Second, the COVID-19 pandemic coupled with the advancement of video-meeting technology forced potential issuers, underwriters and investors to find new ways of building relationships in the context of an IPO. Video meetings have largely replaced most of the in-person one-on-one meetings in roadshows, allowing for more efficient roadshows to be executed in shorter timeframes. For example during the period from 2020 through 2021, underwriters leveraged virtual meeting technology to produce nearly an identical level of exposure, as compared to pre-pandemic times, to the institutional investors who would drive 95% of the demand and the ultimate price of the IPO.

**Crossover Investors – Anchors for an IPO.** The JOBS Act and the ability to have TTW meetings with investors was an initial boon to one sector in particular—biotech. Issuers could have a much better read of a market's willingness to buy their stock in an IPO than was previously available. Moreover, these feedback sessions created relationships and a level of familiarity with a management team for the investors that was previously only developed after an IPO. One could imagine this is particularly salient to investors evaluating the prospects of a new small molecule drug which is likely to be more daunting than evaluating the latest

retail consumer product. As a follow-on development in the market, a select group of traditionally public company investors began seeking to invest in these private biotech companies before they were public. This was termed “crossover” as the investors were crossing over from being public company investors to also being private company investors. These investors not only took board seats and provided counsel to the C suite, they also began to “double down” on their investments by offering to buy more of the companies’ equity in an IPO. This enabled biotech companies to occupy a unique corner of the U.S. IPO market as most biotech IPOs are already “anchored” with demand from existing investors in an IPO. This is in direct contrast to other sectors where one often sees early investors selling at the IPO. The result is the average median sized biotech IPO has doubled in size from \$74 million in 2013 to \$149 million in 2022 and the roadshow is more about filling out investor demand beyond the existing anchors. This change in the market over the past decade has put a particular premium on attracting crossover investors ahead of an IPO. Most crossover investments are made 6-9 months ahead of an IPO which allows for potential step-ups in valuation on the back of an important strategic initiative, such as development with a drug trial for example.

## D. The roadshow

When the company is finally ready to launch the IPO and before the roadshow begins, the company’s management conducts a presentation to the underwriter’s global equity sales force. The presentation signifies the launch of the IPO and the start of the roadshow. The initial management presentation is traditionally recorded and then available for viewing on specialized third-party websites that have bells and whistles that enable them to comply with the applicable SEC rules requiring broad access to the public and that the issuer’s roadshow be accompanied by the prospectus. The presentation can be viewed online by potential investors until the offering is priced.

The table below and much of the following discussion relate to a traditional, in-person roadshow. However, it is worth noting the shift towards conducting virtual roadshows due to the recent coronavirus pandemic. Even during the recent pandemic, which plagued the global IPO markets, IPOs were successfully marketed. The SEC implemented a number of procedural measures designed to facilitate greater use of electronic communications with their staff members. The pandemic also was the catalyst for the widespread adoption of virtual roadshow presentations. This has enabled a greater level of efficiency with the roadshow teams being able to conduct more meetings with investors per day than is the case in a traditional in-person roadshow, which in turn has allowed certain IPOs to be marketed over a shorter marketing period of less than a week (rather than the pre-pandemic norm of 7-9 trading days). Virtual roadshow presentations have survived the pandemic and have continued, in many circumstances, to permit roadshows to be completed in a more efficient and compressed timetable than that presented below.

## Roadshow Basics

### Who is on the Traveling Team?

- Management team (usually CEO and CFO)
- Investment banker(s) (1-2 people)
- Banking salesperson typically introduces each meeting

### Who Will the Company Meet With?

- Roadshow likely to include 50+ individual investor meetings (1x1s) with Institutional Investors and Hedge Funds
- Group presentations and conference calls to larger groups of investors
- Total of 200+ investors touched during course of roadshow

### Where Will the Team Go?

- Typically up to 8 days in the U.S., spanning locations such as: New York (2 days), Boston, Mid-Atlantic, San Francisco, LA, Denver, Chicago
- Option to travel to Europe or reach accounts via conference calls. Companies with important or a critical mass of investors outside the U.S. may also focus on other international locations in an extended roadshow.

## Illustrative Day on Road

▪ 7:00 am	Pick-up from hotel
▪ 7:30 am	Small Group Breakfast
▪ 8:45 am	1x1 Meeting
▪ 10:00 am	1x1 Meeting
▪ 11:15 am	1x1 Meeting
▪ 12:30 pm	Group Luncheon (or travel to 2 <sup>nd</sup> city)
▪ 2:00 pm	1x1 Meeting
▪ 3:15 pm	1x1 Meeting
▪ 4:30 pm	1x1 Meeting
▪ 6:30 pm	Fly to Next City

A roadshow consists of a series of meetings with potential investors in key cities across the country; in certain cases these may extend outside the United States. Top company executives deliver a management presentation covering the company's business and financial performance, along with its products, services and markets. A typical roadshow can include 80 or more one-on-one meetings and several large group presentations with potential investors.

The lead underwriter/bookrunner also assists management in a roadshow's preparation by helping to prepare the slides, rehearsing the presentation with management and preparing educational materials for the sales force (i.e., the salesforce memo). Management presentations should include a summary of the offering and an overview of the company, its financial performance and business strategy, the competitive landscape and investment highlights. You likely have looked at the IPO roadshows of other companies going public—and if you have not you are encouraged to do so at certain specialized third-party websites such as [www.retailroadshow.com](http://www.retailroadshow.com) or [www.roadshowaccess.com](http://www.roadshowaccess.com). It can be a great way to get a sense of how other companies (and even your competitors) are marketing their vision to potential investors.

At the start of the roadshow, equity capital markets and institutional sales force personnel will target investors for you to meet with and begin scheduling one-on-one meetings. The lead underwriter and the



company's management team conduct a roadshow to meet with potential investors. Management on the roadshow will usually include the CEO and CFO and may or may not include one or two other members of the management team, depending on the nature of the business. A biotechnology company, for example, may occasionally include the company's chief science officer on the trip; a fashion company may include their lead designer. Roadshows typically run for between seven and nine trading days, with the longer runs typically occurring if meetings are scheduled overseas. The very largest IPOs will sometimes have two or even three roadshow teams simultaneously conducting meetings on different continents. Along with company management, the roadshow team walking into the investor meetings will typically be the salesperson, who actually scheduled the meeting, the senior banker and junior banker at the underwriter.

Typically an in-person roadshow day involves five to seven one-on-one meetings and/or conference calls, a group breakfast and/or lunch, and travel to the following day's city. For meetings in the mid-Atlantic region, and in certain other densely populated areas, it is not uncommon to visit multiple cities in a single day. However, as noted above, the recent shift towards conducting virtual roadshows has permitted more efficient and compressed timetables, with the roadshow teams able to conduct more meetings with investors per day than in a traditional in-person roadshow.

During the course of the roadshow, the sales force builds a book of orders. "Book building" refers to the process of assessing institutional and retail demand for the issue from investors. Throughout this stage, the lead underwriter determines the appropriate size and price of the offering (as discussed in greater detail below).

During the book building process, the underwriters identify indications of interest, for those that have not set price limits for their orders, as well as investors with scaled orders at different prices. The latter category involves investors who, for example, will take up to 5% of the offering if the IPO is priced at \$11, but only 2% if the IPO is priced at \$13 and nothing at a higher price. There is a fair amount of gamesmanship on both sides with the institutional investors seeking to discover the minimum price they can pay to get the allocation they want and the underwriters seeking to discover whether the institutional investors will actually walk away from the trade if the price is above a certain point or are merely threatening to do so. Each side's position on what would constitute an "acceptable" price can shift multiple times. As a convention, the most interested institutional investors for a particular deal will place a 10% order (meaning they would take up to 10% of the offered shares) with no price limit. Interestingly, this rarely means these investors want or expect this large of an allocation. They are rather indicating to the underwriters that they would like as much of the shares as they can get (which for a hot IPO is never going to be 10% of the issue going to a single investor). These investors would be quite surprised (and usually negatively so) were they actually given 10% of the deal.

It's worth noting that the underwriters will work to build the book with a lot more demand than supply. In other words, the underwriters will strive to obtain orders for the company's stock far north of the amount of stock the company is actually selling in the IPO. Subscription levels of 5-6 times for industrial companies or 15 to 20 times for a technology IPO are not uncommon. During the roadshow these are purely indications of interest as the underwriters build the book and try to achieve the best shareholder base and price for the company. Although the underwriters will be providing continuous feedback to the company, in practice the underwriters will not have a great sense of the strength of the book until the back end of the roadshow as the potential investors are watching the market and evaluating the new company (well, new to them). In an ideal world, the underwriters desire a certain amount of momentum that builds as the roadshow proceeds, seeking for the IPO to be oversubscribed as early in the process as possible.

During this process, the underwriters also will "scrub" the orders, seeking to maximize the number of high-quality accounts, which essentially means institutional investors who will not only hold onto their IPO allocation but will look to add to their position once the stock starts publicly trading (called the aftermarket), thereby helping to drive the momentum in the stock and keeping it from dipping below the IPO price. In other words, the underwriters and the company are effectively selecting who will be the primary shareholder base of the company at the outset of its publicly traded life.

In addition to generating demand from institutional investors, the underwriters will solicit demand from retail investors. Retail investors have the ability to generate substantial demand and are less price sensitive than institutions, but they are rarely assumed to be long-term investors. In fact, the lead underwriters have typically assumed that all of the retail investors are quick-flip investors and will make sure the market can absorb their shares, which sometimes will change hands multiple times in the first day of trading. Retail investors are also more typically price takers and their decisions are more binary—they are either in the offering at a certain price or they are out but they do not have the ability to influence the price of the IPO itself. It is worth noting however that a new development has been the slightly increasing impact that retail investors have had on IPO aftermarket performance in recent years – especially in well known consumer-oriented names and technology companies – leading to new retail-oriented platforms beginning to be incorporated into some IPO syndicates.

## **E. Price and allocation**

The lead underwriter attempts to achieve the most appropriate price for the company, while building a high-quality shareholder base. As mentioned earlier, high-quality investors are sought in order to achieve an attractive valuation for the company as well as to provide the best framework for the stock to trade well when the IPO prices and onward. Generally, the goal in setting the IPO price is to achieve a valuation that is

at a discount to the price the stock will sell for in the public market once it opens for trading. Depending on the level of uncertainty surrounding the valuation of the company and the peer-company volatility, such IPO discount could be up to 10 percent or greater. The IPO discount is designed to reward the initial investors in an IPO for accepting the risk associated with the new issue of stock that does not have an established trading market or a track record of reporting earnings, filing documents with the SEC and conducting earnings calls as well as to generate the impression of a successful IPO and interest in subsequent offerings of the company's stock.

Once a company prices its IPO, the lead underwriter begins the process of identifying those investors that will receive shares and the amount allocated to each. The allocation of shares at the IPO represents the core of a company's shareholder base. A high-quality initial shareholder base creates long-term partnerships and attracts other quality investors. Typically between 80% and 90% of shares in an IPO are allocated to institutions, with the remaining 10% to 20% going to retail investors. The lead underwriter will send the proposed allocation to the company at the agreed price for the company's review and approval. At the conclusion of the allocation process and before the market opens, the lead underwriter contacts the investors to let them know how many shares they will receive and at what price. After all the IPO shares have been allocated and confirmed with accounts, the underwriters break the syndicate and the deal begins trading the next day.

## **F. Stabilization and the overallotment (or “greenshoe”) option**

In a typical IPO, the underwriters will allocate more shares to investors than are being sold by the company. This is called creating a short. So if the IPO offering is for 10,000,000 shares, the underwriters will typically allocate 11,500,000 shares to institutional and retail investors at pricing, thereby creating a 15% short position. To cover this short position, the underwriters have two options. First they can buy the shares in the open market after the stock starts trading if it trades below the IPO price—this is called stabilizing the stock and is undertaken on behalf of the underwriting syndicate by one of the banks who will act as the stabilization agent. It is a way to facilitate the stock's trading and give investors some comfort that the stock won't immediately go below the IPO price once it opens for trading. Second, the underwriters can exercise their over-allotment option to purchase stock directly from the company. This option is called the “greenshoe”; so named because it was first used in the stock offering for Green Shoe Manufacturing (now called Stride Rite Corporation). In an IPO, the greenshoe will be for 15% of the offering, as in the example given above. If the underwriters do not have to purchase stock in the open market to stabilize the offering, or do not have to purchase all 15% of the shorted shares, they can exercise the greenshoe in whole or in part to cover their short for up to 30 days after the IPO is completed (in this case buying the shares from the company to deliver to the investors who bought at the IPO).

In circumstances where the underwriters believe the stock may come under intense selling pressure after the IPO because of market conditions, the underwriters may sell more than 115% of the offering in the initial allocation to institutional and retail investors. This is called creating a naked short. Naked because the underwriters have to purchase at least some shares in the market to cover their short (they are selling more shares than what they are buying from the company under the underwriting agreement, including the greenshoe) so the underwriters are exposed for any losses should the stock trade up after the offering prices. Needless to say, underwriters are loathe to create naked shorts unless they strongly believe they can cover this short at or below the IPO price.

## G. A few words on direct listings

### ***WHAT IS A DIRECT LISTING AND HOW DOES IT DIFFER FROM A TRADITIONAL IPO?***

A direct listing occurs when a private company goes public by listing its stock on a national stock exchange, such as NYSE or Nasdaq, without simultaneously also undertaking an underwritten public offering.

In many ways the direct listing process is quite similar to a traditional IPO. The registration statement, including the financial statements, and the process of having it reviewed by the SEC is substantially the same as that in a traditional IPO. In addition, the overall timeline and diligence process are likely to be roughly similar. Moreover, many of the expenses borne by the listing company will be comparable—for example, fees for counsel and auditors, SEC registration fees, listing fees paid to the relevant exchange, and even the fees of a financial printer will all be similar to a traditional IPO. And, as with a traditional IPO, the listing company will be required to satisfy the relevant stock exchange's listing requirements and governance standards.

However, because the transaction is not underwritten, there is no underwriter-led book building process, no commitment on the part of the company or selling stockholders to sell a specific number of shares and no fixed initial public offering price negotiated with underwriters. Instead, on the first day of trading, any stockholder listed in the company's registration statement may simply sell their shares through a broker at whatever price they are able to obtain in the market, in an auction-based process. Until recently, only shares owned by existing stockholders, such as employees and pre-IPO investors, could be sold as part of a direct listing and, accordingly, the company did not raise new capital (which resulted in the costs of the offering being expensed for accounting purposes rather than capitalized). This changed recently when the SEC approved new listing rules from the NYSE and Nasdaq, respectively, permitting companies to raise new capital through a direct listing, provided certain market valuation requirements and initial listing requirements are satisfied.

Even though a direct listing does not necessarily utilize underwriters, all of the major companies who have completed a direct listing to date have hired traditional investment banks to act as financial advisors and assist them with the listing process, including to help the company craft its investment thesis and with preparation of the registration statement and investor communications and presentations. In order to avoid being deemed “underwriters” (and thereby taking on underwriting liability), these financial advisors do not themselves actually participate in investor meetings or otherwise conduct price discovery activities or sales of stock. In a traditional IPO, the issuer may rely on its underwriters to generate lists of potential investors and contact them, to host pre-deal investor education sessions and a roadshow and to train and deploy a salesforce to sell the company’s shares. The issuer may also rely on the research analysts at its underwriting firms to provide coverage. The absence of underwriters and the limitations on the services financial advisors can provide without risking taking on underwriting liability means that much of the traditional marketing of an offering must be either forgone or managed by the issuer. As a result, many companies, and particularly those without a high public profile or those who lack a robust investor relations capacity, may find the marketing process of a direct listing more burdensome and challenging than a traditional IPO. To date, the few direct listings that have been completed were most often widely recognized companies with large market capitalizations. So far, at least as of the time that this book went to press, no companies have used the option for a primary direct listing.

It remains to be seen whether direct listings will gain in popularity following the exchange rule changes permitting primary offerings (and subsequent rule changes further streamlining the pricing requirements in a primary direct listing) as well as a recent Supreme Court ruling limiting potential liability under Section 11 of the Securities Act, as discussed in Chapter VIII (Life as a Public Company). In June 2023, in a case arising out of the 2019 direct listing of Slack Technologies, Inc., the Supreme Court unanimously held that a plaintiff who purchases shares in a direct listing must trace his shares to a false or misleading registration statement to state a Section 11 claim. This “traceability” requirement can prove difficult for a plaintiff in a direct listing because only a portion of the shares traded on the IPO date and thereafter are sold under a registration statement relating to pre-IPO shares held by affiliates of the issuer and others that hold “restricted securities,” while unrestricted shares held by non-affiliates are freely tradeable and sold without utilizing a registration statement.

In a direct listing each of the company’s financial advisors is generally paid a flat engagement fee rather than discounts or commissions on the shares sold as is the case in a traditional IPO. While the fees earned by financial advisors in some direct listings have to date generally been equivalent to what that bank would have earned in a conventional underwritten IPO as a bookrunner, because there have been fewer financial advisors than there would typically be underwriters, the aggregate fees paid by the companies to its financial advisors (banks) have ended up being lower. This fee dynamic may evolve over time as the

potential to significantly lower the costs associated with an initial public offering has been one of the stated drivers for those who have advocated direct listings. Notwithstanding how these financial advisor fees may evolve, they are likely to remain a significant expense. And, whereas the underwriters in a traditional IPO are compensated by underwriting discounts or commissions borne by the seller of the shares (which is the issuer in the case of primary shares or the selling stockholders in the case of secondary shares), to date the issuers have borne the full cost of these financial advisors. This is compounded by the accounting consequence noted above that requires offering expenses in a secondary offering to be expensed and not capitalized.

In addition to the company's financial advisors, both the NYSE and Nasdaq require that the listing company appoint a financial advisor to provide an independent valuation and assist the exchange's market maker or specialist, as applicable, in setting a reference price for the opening of trading. The exchange weighs both this valuation and the pricing of the company's stock in the private placement market prior to the IPO in determining the reference price. The reference price is published by the exchange shortly before trading begins as a starting point for price discovery between potential buyers and sellers in the stock. Unlike a traditional IPO, the company does not get to determine or consult on the reference price.

#### ***WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF A DIRECT LISTING AS COMPARED TO A TRADITIONAL IPO?***

In addition to the advantage of potentially lowering the fees payable to investment banks, the other advantages and disadvantages of a direct listing as compared with a traditional IPO are sometimes viewed as opposite sides of the same coin. For example, a common and perennial complaint by pre-IPO institutional investors and companies is that traditional IPOs are often priced too low with too great of an IPO discount. Varying theories abound as to why this occurs, but regardless, a successful IPO almost always has an IPO "pop" where the price increases significantly during the first day of trading from the IPO price. While this is advantageous for those buying directly in the IPO, companies and selling shareholders often feel that value directly came out of their pockets and, in addition to the direct expenses, is a significant cost of undertaking a traditional IPO. A correctly calibrated direct listing, by contrast, should in theory find the "true" market clearing price in its auction methodology and therefore not "leave any money on the table."

However, a direct listing lacks many of the mechanisms of an underwritten offering intended to decrease price volatility in the initial trading. For example, there can be no assurance in a direct listing that there will be an adequate supply of stock for sales or interested buyers when trading opens to create an efficient market for the stock. The underwriters' book building process in a traditional IPO can be a very effective price discovery tool and investors and sellers participating in a direct listing do not have the benefit of

reference to an initial public offering price or price range based on this process. In addition, direct listings do not feature a stabilizing agent bank with the benefit of an overallotment (or “greenshoe”) option that can enter into transactions intended to stabilize the trading price in the period immediately after the IPO.

Proponents of direct listings also frequently espouse the more “democratic” and transparent nature of the process in contrast to that of a traditional IPO. Because the company or any stockholders listed in the registration statement for a direct listing can simply sell their stock to whatever buyers are willing to buy it, the profile of the company’s public investors, at least in the near term, is likely to be different, potentially including fewer large institutional positions and more retail investors who might otherwise have been unable to participate by buying stock directly in a traditional IPO rather than only in aftermarket trading. However, this method of distribution may also increase trading volatility and does not afford the company with the opportunity that it has in a traditional IPO to allocate shares to investors who are expected to take relatively stable, long-term positions in the company. Direct listings may also tend to be more popular among employees and other existing stockholders because of the greater immediate participation and flexibility they offer these stockholders, particularly in that direct listings generally do not require existing stockholders to sign lock-up agreements restricting their ability to sell shares following the listing, whereas most traditional IPOs usually subject management and significant stockholders to contractual sales restrictions for 180 days. However, the impact of unrestricted sales on the trading market of a new issue can also, like other features of the direct listing process, result in increased trading price volatility.

## H. A few words on special purpose acquisition companies (“SPACs”)

### ***WHAT IS A SPAC? AND HOW DOES GOING PUBLIC THROUGH A TRANSACTION WITH ONE DIFFER FROM A TRADITIONAL IPO?***

A SPAC is a newly formed blank check company, usually organized by a “sponsor,” that goes public with the promise to its IPO investors that it will use its IPO proceeds or the equity of the SPAC, or both, to merge with a private operating company within a specified period of time (typically 12 to 18 months, subject to a maximum of 36 months). This process provides an alternative to the traditional IPO route for a private operating company as it effectively can “go public” by merging with a SPAC. SPACs generally disclose at the time of their IPO that they have not identified a target private operating company, which reduces the regulatory disclosures required for that IPO and provides the SPAC with flexibility. However, if a SPAC fails to identify a target private operating company and complete a merger within the specified period of time, the SPAC must obtain shareholder approval to extend its life or return the proceeds it raised in its IPO to its shareholders.

Once the SPAC identifies a target private operating company and the two companies have entered into a letter of intent, it is typical that binding commitments are sought from institutional investors to make a private investment in public equity (“PIPE”) into the combined business in order to supply additional capital. These PIPE commitments are generally obtained prior to public announcement of the merger between the SPAC and the private operating company target and prior to the preparation and filing of SEC disclosures regarding the private operating company. A successful PIPE is generally a predicate for the execution of definitive merger documentation, and the terms of that merger documentation can vary significantly from the original letter of intent based upon the feedback from the PIPE investors. The capitalization structure of the SPAC, along with agreed upon terms in the merger documentation will, however, invariably provide for the SPAC sponsor to receive a portion of the equity in the combined company as compensation for fronting the capital to form and operate the SPAC prior to the merger. After execution of the PIPE subscription agreements and definitive merger documentation, SEC disclosure filings, such as registration statements and/or proxy statements, are then required to be filed with the SEC and are subject to SEC review. The disclosures regarding the private operating company target and combined business are similar in many ways to the disclosures required for a traditional IPO. Once the SEC review process is cleared, the SPAC holds a shareholder meeting to approve the merger. However, while the SPAC’s arrangements typically incentivize its public shareholder to vote in favor of the merger, these shareholders are nonetheless permitted to redeem their shares (i.e., to get their money back, with interest), which typically will occur if the trading price of the SPAC in anticipation of the merger is expected by SPAC shareholders to trade below the SPAC’s IPO price. Accordingly, it is possible that the only significant funding that will be available to the combined company at the time of completion of the merger will be the proceeds raised from the PIPE, with trading in the combined company being illiquid due to the absence of any significant retail participation or research coverage from Wall Street analysts.

While SPACs have been around for decades, SPAC transaction activity rose sharply in 2020 and early 2021. As a result of subsequent poor market performance, the interest of institutional investors in PIPE transactions has diminished, leading to a largely frozen SPAC market as of the date this book went to press. Further, an SEC rule proposal changed the risk profile of SPAC mergers and accordingly, SPACs are now less attractive for many companies due to the increased regulatory scrutiny and risk.



## VIII. Life as a public company

### A. Only the beginning

The IPO is not the end of the story—it is only the beginning. At least one of the authors likens going public to preparing for and running a marathon—except that after finishing the grueling 26.2 miles, instead of feasting on bananas and other post-race goodies and relaxing after wrapping yourself in one of those foil blankets, you then have the pleasure of immediately embarking upon a regimen of running quarterly wind sprints where a crowd of analysts and the media are waiting at the finish line of each race to punch you in the gut. Thus is the reality for a company going public.

As discussed in Chapter III (Planning Ahead—What Should I Be Thinking About Now?), the preparation for going public should happen in parallel with the IPO. Take stock of your processes and infrastructure so that you can address any gaps well in advance of the IPO date. This preparation process can often be lengthy, depending on the maturity of existing processes. How significant the required improvements are will determine the number of resources required. Many companies have resource constraints during the going public process, where there is so much attention being paid to the IPO filings and marketing efforts that other efforts may find themselves de-prioritized. Find a way to keep these efforts at the forefront!

Oceans of ink have been spilled on treatises, guides, manuals and other materials about the myriad requirements that apply to public companies and how to comply with them, and a comprehensive discussion of that subject is well beyond the scope of this book. But, we do think it helpful to cover briefly the basics of the ongoing public reporting obligations, as an understanding of these informs to a significant degree the work that is entailed in preparing your company's finance organization and other functions for the rigors of being public.

Before diving in, we would be remiss if we failed to note that the reporting obligations of a public company only tend to grow more burdensome over time. For example, just since the prior edition of this book was published, public companies have become subjected to additional disclosure requirements related to share repurchase activity, Rule 10b5-1 trading plans, and cybersecurity. And there are additional potential disclosure requirements on the horizon. Although it cannot be known at this time what rules will ultimately be adopted, the SEC is expected to propose rules for expanded human capital disclosures and finalize rules for climate change disclosures. The SEC's proposed rules for climate change disclosures, as of the date this book went to press, would require public companies to disclose risks and material impacts to their business, strategy, and outlook caused by climate change; greenhouse gas emissions; additional

qualitative and quantitative climate risk disclosures, including the financial impacts of severe weather events; and governance of climate-related risks and risk management processes. The PCAOB has also proposed amendments to PCAOB auditing standards related to the auditor’s responsibility for considering a company’s noncompliance with laws and regulations in an audit. While any rules and standards ultimately adopted could look significantly different than current proposals and be subject to legal challenge, the proposals themselves are emblematic of the principle that the pressures on public companies only grow over time.

## B. Ongoing reporting

**Annual and quarterly reporting.** The SEC requires public companies to file quarterly reports on Form 10-Q and annual reports on Form 10-K (these 10-Qs and 10-Ks sometimes being referred to collectively as “periodic reports”), with current information regarding the company’s business and financial condition. In a way, these reporting obligations can essentially be viewed as a requirement to periodically update the registration statement that the company used in the IPO. For example, just as the registration statement used in the IPO included the company’s financial statements, the company’s periodic reports must update those financial statements. Thus, the company’s annual report on Form 10-K will need to contain an updated audited balance sheet and audited income statement, cash flows and changes in shareholders’ equity. And for the quarterly reports on Form 10-Q, the company will need to provide the public with its interim financial statements (not generally audited but a review by the outside auditors is required).

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A “large accelerated filer” is any issuer meeting the following conditions as of the end of its fiscal year:

1. the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates of the issuer was \$700 million or more as of the last business day of the issuer’s most recently completed second quarter;
2. the issuer has been subject to reporting requirements under the Exchange Act for at least 12 calendar months;
3. the issuer has filed at least one annual report under the Exchange Act; and
4. had annual revenues of \$100 million or more.

An “accelerated filer” is any issuer meeting the following conditions as of the end of its fiscal year:

1. the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates of the issuer was \$75 million or more, but less than \$700 million, as of the last business day of the issuer’s most recently completed second quarter; and
  2. it meets conditions (2)–(4) of the definition of “large accelerated filer.”
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**Public float:** For purposes of determining accelerated filer and large accelerated filer status, public float represents the aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer computed by use of the price at which the common equity was last sold, or the average of the bid and asked prices of such common equity, in the principal market for such common equity, as of the last business day of the issuer’s most recently completed second fiscal quarter.

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A new issuer has 90 days after the completion of its fiscal year to file its first annual report on Form 10-K with the SEC. Thereafter, the timetable for a “large accelerated filer” (generally, a company that has been reporting with the SEC for at least a year and has a public float of at least \$700 million and annual revenues of \$100 million or more) is 60 days and the timetable for an “accelerated filer” (generally, a company that has been reporting with the SEC for at least a year and has a public float of at least \$75 million (but less than \$700 million) and annual revenues of \$100 million or more) is 75 days. Note, the thresholds for exiting accelerated and non-accelerated filer status differ from those used to determine initial filer status. A new issuer has 45 days after the completion of each of the first three fiscal quarters of the year to file its quarterly reports on Form 10-Q prior to its second annual report on Form 10-K. Thereafter, the timetable for a large accelerated filer and an accelerated filer is 40 days. We should point out that a new issuer is permitted to file its very first quarterly report within 45 days following the effective date of its registration statement if this is later than the due date for the report that would otherwise have applied.

Category of filer	Form 10-K deadline	Form 10-Q deadline
Large accelerated filer	60 days	40 days
Accelerated filer	75 days	40 days
Non-accelerated filer	90 days	45 days

Sarbanes-Oxley requires the chief executive officer and chief financial officer of an issuer to make certifications pursuant to Sections 302 and 906 of Sarbanes-Oxley with respect to its annual reports on Form 10-K and quarterly reports on Form 10-Q. These certifications relate to the accuracy of the annual report, including financial statements. The 906 certifications also cover compliance with applicable SEC rules and the 302 certifications also cover the issuer’s internal control over financial reporting and disclosure controls and procedures. These certifications must be filed as exhibits to such reports.

As discussed in Chapter IV (Building a Public Company Finance Organization), commencing with their first quarterly report on Form 10-Q, issuers must submit with their periodic reports (and any current report on Form 8-K that contains a revised version of previously filed audited annual financial statements) specified financial information in such financial statements in an interactive data format known as eXtensible Business Reporting Language (XBRL). XBRL consists of computer-readable tags which are used to identify each piece of financial data with the goal of enabling more efficient retrieval and analysis of the information. As discussed above, as part of its efforts to modernize, the SEC may consider additional opportunities for XBRL tagging, such as in proxy-voting disclosures.

**Earnings releases.** As part of the periodic process for reporting earnings, many companies will issue quarterly earnings releases and conduct related conference calls with investors. Companies should carefully consider the process they adopt for releasing earnings to ensure it comports with all applicable regulatory requirements. Among other things, earnings releases are required to be furnished on a Form 8-K report to the SEC and must satisfy SEC rules relating to the use of non-GAAP financial measures. Particular care should be taken with respect to the initial quarterly earnings releases and conference calls following the IPO, as any “surprises” can be used as the basis for a lawsuit under Section 11 of the Securities Act asserting that the IPO prospectus contained a material misstatement or omission.

**Current reporting.** A public company is also required to file a current report on Form 8-K (generally within four business days) when certain specified events occur. The quick reference guide below summarizes these events, which many are surprised to learn do not include a “catch-all” requirement that the company

file a Form 8-K whenever something “material” happens. Rather, the list includes a grab bag of enumerated matters, some of which may fairly be said to be plainly not material. The list also continues to grow. For example in July 2023, the SEC adopted rules that require current reporting of cybersecurity incidents deemed by the registrant to be material.

## Form 8-K Quick Reference Guide<sup>1</sup>

### Triggering Events

#### Business and Operations

- Execution, amendment or termination of a material definitive agreement not made in the ordinary course of business (Items 1.01/1.02).
- Bankruptcy or receivership; court or governmental order confirming plan of reorganization, arrangement or liquidation (Item 1.03).
- Material cybersecurity incident, defined as an unauthorized occurrence, or a series of related unauthorized occurrences, on or conducted through a registrant’s information systems that jeopardizes the confidentiality, integrity, or availability of a registrant’s information systems or any information residing therein (Item 1.05).

#### Financial Information

- Acquisition or disposition of a significant amount of assets other than in the ordinary course of business (Item 2.01).
- Public announcement or release (including any update to earlier announcement or release) disclosing material non-public information regarding results of operations and financial condition for a completed quarterly or annual fiscal period (Item 2.02).
- Creation of a material (i) direct financial obligation or (ii) direct or contingent obligation arising out of an off-balance sheet arrangement (Item 2.03).
- A triggering event causing (i) the increase or acceleration of (A) a direct financial obligation or (B) an obligation under an off-balance sheet arrangement or (ii) a contingent obligation under an off-balance sheet arrangement to become a direct financial obligation, and such events under (i) and (ii) having material consequences (Item 2.04).
- Committing to an exit or disposal plan or otherwise disposing of a long-lived asset or terminating employees under certain plans that results in a material charge under GAAP (Item 2.05).
- Conclusion that a material impairment charge to assets is required under GAAP (unless conclusion is made as part of a quarter/year-end process and is disclosed in the next periodic report); includes impairments of securities or goodwill (Item 2.06).

<sup>1</sup> This guide is only a summary and does not include all situations under which a Current Report on Form 8-K is required to be filed.

## Triggering Events

### Securities and Trading Markets

- With respect to a national securities exchange/association: (i) notice therefrom of non-satisfaction of a listing rule/standard or of delisting; (ii) notice thereto of a material noncompliance with a listing rule/standard; (iii) a public reprimand letter or similar communication therefrom for a violation of a listing rule/standard; or (iv) the taking of definitive action to delist therefrom or transfer listing to another securities exchange/association (Item 3.01).
- Unregistered sales of equity securities that in the aggregate constitute 1% or more of the outstanding shares of the class sold (Item 3.02).
- Material modifications, limitations or qualifications to the rights of holders of any class of registered securities (Item 3.03).

### Accountants and Financial Statements

- Resignation or dismissal of an independent accountant or engagement of a new independent accountant (Item 4.01).
- Concluding (or being advised by or receiving notice from the independent accountant) that previously issued financial statements should no longer be relied upon (Item 4.02).

### Corporate Governance and Management

- Change in control (Item 5.01).
- Director's or certain executive officers' resignation, retirement, termination or removal or director's refusal to stand for reelection. Election of new director or appointment of certain new executive officers. Entry into or adoption of a material compensatory plan, contract or arrangement to which the principal executive officer, principal financial officer, or a named executive officer is a party or participates; all material amendments to such plan, contract or arrangement; or material grants or awards thereunder to any such persons. Calculations of compensation figures for named executive officers if omitted from Summary Compensation Table (Item 5.02).
- Amendments to the articles of incorporation or bylaws (not disclosed in a proxy statement) or a change in fiscal year (Item 5.03).
- Temporary suspension of trading under an employee benefit plan (Item 5.04).
- Amendment to, or waiver from, a provision of the code of ethics that applies to the principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions (Item 5.05).
- Submission of matters to a vote of security holders (Item 5.07).
- Shareholder director nominations (Item 5.08).

### Regulation FD

- Disclosure of information pursuant to Regulation FD (Item 7.01).

### Other Events

- Optional disclosure of other events deemed of importance to security holders (Item 8.01).

### Financial Statements and Exhibits

- Disclosure of financial statements, pro forma financial information and exhibits, if any, filed as part of the 8-K (Item 9.01).

In addition to the obligation to file current reports on Form 8-K with the SEC, the NYSE and Nasdaq expect listed companies to release timely to the public any information which might reasonably be expected to materially affect the market for their securities, except under very limited circumstances where it is possible to maintain confidentiality of the information and immediate public disclosure would prejudice the ability of the company to pursue its legitimate corporate objectives. In the case of NYSE-listed companies, when the announcement of news of a material event or a statement dealing with a rumor which calls for immediate release is made between 7:00 a.m. and 4:00 p.m., New York time, the company must notify NYSE's Market Watch & Proxy Compliance team by telephone at least ten minutes prior to release of the announcement and a copy of the press release must be submitted via email to NYSE. Nasdaq-listed companies must notify Nasdaq's MarketWatch Department at least ten minutes prior to the release to the public of material information that involves certain events, including but not limited to financial-related disclosure, corporate reorganizations and acquisitions, new products or discoveries, developments regarding customers or suppliers, senior management changes, independent auditor changes, events regarding the company's securities, and significant legal or regulatory developments, if the public release of the information is made between 7:00 a.m. and 8:00 p.m., New York time; if the information is released between 8:00 p.m. and 7:00 a.m., New York time, companies must notify Nasdaq's MarketWatch Department of the material information prior to 6:50 a.m., New York time.

**Proxy statements.** A proxy statement contains information provided to shareholders so they can decide how to vote in connection with a company's shareholder meeting. Stock exchange rules and, typically, state law require a company to hold an annual shareholder meeting, and stock exchange rules require a company to solicit proxies for all meetings of shareholders. In connection with such solicitation, a proxy statement must be prepared, filed with the SEC and disseminated to the shareholders. In cases where a company's stockholders vote or act by written consent without the solicitation of proxies, SEC rules require the company to provide stockholders with an information statement, which contains disclosure substantially similar to that required in a proxy statement. Certain information required to be disclosed (including the required compensation disclosures) in an issuer's annual report on Form 10-K may be incorporated by reference to the issuer's later-filed proxy statement as long as the proxy statement is filed within 120 days after the end of the issuer's fiscal year.

**Internal control over financial reporting and other disclosure controls and procedures.** A public company must maintain internal control over financial reporting, which is a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

The company must include in its annual reports on Form 10-K a management's assessment of the effectiveness of its internal control over financial reporting. The rules provide that companies are exempt from this requirement for their first annual report on Form 10-K, so it first kicks in with the second annual report on Form 10-K that is filed. In addition, companies that are accelerated filers or large accelerated filers must also, starting with their second annual report on Form 10-K (if the company is an accelerated filer or large accelerated filer for purposes of that report), include an opinion from the issuer's outside auditors on the effectiveness of the issuer's internal control over financial reporting. Notwithstanding the foregoing, however, under the JOBS Act a company that qualifies as an EGC is exempt from the requirement to include the attestation from the issuer's outside auditors on the effectiveness of the company's internal control over financial reporting until the earlier of 5 years or when an entity is no longer an EGC. Due to SEC rule updates in 2020, a smaller reporting company with annual revenue of less than \$100 million likewise does not have to include an annual attestation report of its auditors on the effectiveness of the company's internal control over financial reporting, although larger companies (other than EGCs) must do so.

A public company must also disclose in its quarterly reports on Form 10-Q and annual reports on Form 10-K any change materially affecting its internal control over financial reporting that occurred during the issuer's last fiscal quarter, beginning with its first periodic report following its IPO. The issuer's principal executive officer and principal financial officer must certify that they have disclosed to the issuer's auditors and audit committee all significant deficiencies or material weaknesses in the design or operation of internal controls.

In addition, a public company must maintain disclosure controls and procedures, which are controls and other procedures of the issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. An issuer must evaluate the effectiveness of its disclosure controls and procedures and describe its evaluation quarterly in its quarterly reports on Form 10-Q and annual reports on Form 10-K.

**Regulation FD.** Whenever a public company, or any person acting on its behalf, discloses, whether intentionally or not, any material non-public information regarding that issuer or its securities to securities market professionals or securityholders (if it is reasonably foreseeable that the securityholder will trade on the basis of the information), Regulation FD requires the issuer to make general public disclosure of the information. Public disclosure must be made simultaneously for intentional disclosures and promptly (but in no event after the later of 24 hours or the commencement of the next day's trading) in the case of inadvertent disclosures. Regulation FD does not apply to disclosures made to persons who owe a duty of trust or confidence to the issuer, persons with a confidentiality obligation or to certain offering-related



communications. Regulation FD also does not apply to communications to employees, but for any broadly-based employee communications, a company should consider whether public disclosure is prudent under Regulation FD.

## C. Liability under the federal securities laws

Unfortunately, given the legal regime in the United States, inherent in conducting an IPO and life as a public company thereafter is the reality that you can be exposed to, frequently frivolous, lawsuits.

Liability under the U.S. securities laws in connection with an IPO primarily arises under the Securities Act and the Exchange Act. The SEC has broad powers to investigate public companies and their directors and officers and to bring civil enforcement proceedings that could result in fines and monetary penalties or other sanctions, such as a bar from serving as a director or officer of a public company. In addition, a public company and its directors and officers could also become subject to criminal liability for, among other things, willful violations of securities laws or interference with a government investigation. Finally, many of the provisions of the securities laws also provide for private rights of action in which investors individually or as representatives of a class can bring a lawsuit against the company and its directors and officers. These private class action lawsuits are the most common proceeding to which companies and their directors and officers are subject for alleged misstatements or omissions in connection with registered securities offerings.

- Securities Act, section 11 liability: under section 11, the issuer, its directors, its principal executive, financial and accounting officers, its underwriters and a foreign issuer's authorized US representative can be liable for material misstatements or omissions in the issuer's registration statement. 'Experts', such as the issuer's accountants, can also be held responsible and sued directly for misrepresentations made on their authority. Section 11 entitles a purchaser of securities in a registered offering, or whose securities are 'traceable' to those distributed in such offering, to obtain damages for a violation. While the issuer is subject to strict liability for material misstatements and omissions in its registration statement, non-issuer defendants (i.e., all defendants, other than the issuer itself) are afforded, among other defenses, an affirmative 'due diligence' defense if they can show that 'after reasonable investigation, [they had] reasonable ground to believe and did believe' that statements made in the registration statements were not misleading.
- Securities Act, section 12 liability: under section 12(a)(2), the issuer, its officers and directors, its underwriters and other persons can be liable if they sell or solicit the sale of a security by means of a prospectus or an oral communication containing a material misstatement or omission. Section 12(a)(2) permits a purchaser of securities in a registered offering, or whose securities are

‘traceable’ to those distributed in such offering, to obtain rescission of the sale, or damages in certain circumstances. Non-issuer defendants similarly have an affirmative defense if they ‘did not know, and in the exercise of reasonable care could not have known,’ of the misrepresentation.

- Securities Act, section 15 liability: under section 15, any person who ‘controls’ a primary violator of section 11 or 12 can also be held liable under a theory of secondary liability. ‘Control’ exists if the defendant has the direct or indirect power ‘to direct or cause the direction of the management and policies’ of the primary violator (typically the issuer) through stock ownership, contract or other means. Control person claims are frequently asserted against officers and directors of issuers, and can be brought against a controlling shareholder or group of shareholders, in connection with section 11 and 12 lawsuits. Defendants have an affirmative defense if they ‘had no knowledge of or reasonable ground to’ know the facts underlying the violation.
- Exchange Act, section 10(b) and rule 10b-5: a section 10(b) and SEC rule 10b-5 claim is the most commonly asserted claim against public companies, officers and directors, underwriters and accountants and other persons. A claim can be brought for use of ‘any device, scheme or artifice to defraud’, any material misstatement or omission, or ‘any act, practice, or course of business’ that deceives in connection with the purchase or sale of securities. A claim can be brought concerning statements made in connection with a public offering or with secondary market trading based on misstatements made in press releases, officer or director communications and periodic reporting, among other things. Unlike the Securities Act claims discussed above, however, in order to establish a violation of section 10(b) a defendant must be shown to have had ‘scienter’—an intent to defraud or otherwise engage in reckless conduct. The plaintiff must also demonstrate ‘loss causation’—a connection between the defendant’s alleged misconduct and the economic harm suffered.
- Exchange Act, section 20(a): similar to section 15 of the Securities Act discussed above, section 20(a) of the Exchange Act provides for secondary liability of any person who ‘controls’ a primary violator of section 10(b) or rule 10b-5 can also be held liable under a theory of secondary liability. Section 20(a) provides an affirmative defense for persons who acted ‘in good faith and did not directly or indirectly induce [. . .] the violation’.

As mentioned above, section 11 of the Securities Act provides non-issuer defendants (including directors, officers and underwriters) with an affirmative ‘due diligence’ defense if they can show that ‘after reasonable investigation, [they had] reasonable ground to believe and did believe’ that statements made in the registration statement were not misleading. Similarly, non-issuer defendants have an affirmative defense to a claim under section 12 of the Securities Act if they ‘did not know, and in the exercise of reasonable care could not have known’ of the alleged misrepresentation. Defendants in a Securities Act, section 15 or Exchange Act, section 20 ‘control person’ claim have an affirmative defense if they ‘had no

knowledge of or reasonable ground to' know the facts underlying the violation or acted in 'good faith', respectively. A defendant in an Exchange Act, section 10(b) or rule 10b-5 claim must be shown to have had an intent to defraud or been reckless. A non-issuer defendant that is able to establish that he or she or it performed a reasonable investigation sufficient to establish an affirmative defense under section 11 will typically also be thereby able to defeat claims under each of the other provisions as well. It is for the purposes of establishing such a defense under section 11 and these other provisions that underwriters and other offering participants engage in extensive due diligence on the issuer and its business in connection with an IPO. It should be noted that, as a procedural matter, the affirmative due diligence defense, typically, is not available at the incipient 'motion to dismiss' stage of a securities litigation (when a plaintiff's allegations must be assumed to be true), but rather only after discovery has been taken and the defendant moves for 'summary judgment'. An issuer arriving at this later stage of a securities litigation will typically have already incurred significant expense, and companies accordingly have a significant incentive to settle these actions.

## D. Parting thoughts

The authors wrote this short book to answer the questions we are most commonly asked by business owners and executives who are contemplating an initial public offering of their company. As we noted in our introduction, however, this book is not a "how to" manual and, if you choose to move forward with an IPO, we encourage you to add to your team experienced advisors who know all of the ins and outs and advise companies going public for a living. It takes time to prepare a private company to go and be public, and this process will be much more manageable if you start early, objectively assess the areas where your company's capabilities need to be enhanced and then develop and methodically implement a realistic plan to address these.

We hope you found this book helpful and wish you the very best of luck! Please do not hesitate to contact any of us with any questions.

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